REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

HEARINGS

BEFORE THE

SUBCOMMITTEE ON CONSERVATION, CREDIT, AND RURAL DEVELOPMENT

OF THE

COMMITTEE ON AGRICULTURE
HOUSE OF REPRESENTATIVES

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REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

TUESDAY, MARCH 18, 1986

House of Representatives,
Subcommittee on Conservation,
Credit, and Rural Development,
Committee on Agriculture,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:05 a.m., in room 1300, Longworth House Office Building, Hon. Ed Jones (chairman of the subcommittee) presiding.

Present: Representatives Weaver, Glickman, Daschle, Stenholm, Evans of Illinois, Thomas, Coleman, Jeffords, Morrison, Gunderson, and Evans of Iowa.

Also present: Representative E (Kika) de la Garza, chairman of the committee; Representative English, member of the committee; Representative Smith of Iowa.

Staff present: Phillip L. Fraas, counsel; Charles Rawls, associate counsel; William E. O'Conner, Jr., assistant minority staff director; John E. Hogan, minority counsel; Mark Dungan, minority associate counsel; Glenda L. Temple, clerk; Bernard Brenner, Robert A. Cashdollar, James W. Johnson, Jr., Fred Clark, and Susan Adkins.

OPENING STATEMENT OF HON. ED JONES, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TENNESSEE

Mr. Jones of Tennessee. Today the subcommittee begins its consideration of reauthorization of the Commodity Futures Trading Commission. It certainly doesn't seem like it's been 4 years since we last considered this issue.

I want to congratulate both the CFTC and the commodities industry for making this a relatively quiet 4 years. I believe that market users and the public in general can be reassured that the CFTC has become a mature, a competent, and stable regulator in its short 10 years of life.

Further, I also have seen strong evidence that the futures industry is accepting the responsibility which comes with its growing importance in the national and world economies. It is extremely important that all of us attempt to see the big picture and not let short-term considerations divert our attention from what's in the long-term best interests of this dynamic and creative industry.

During the next 2 days the subcommittee will hear from a broad spectrum of witnesses who represent practically all views of the situation. I look forward to all the testimony and hearing what members of the subcommittee have on their minds.

Mr. Coleman, you are recognized.

OPENING STATEMENT OF HON. E. THOMAS COLEMAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MISSOURI

Mr. **Coleman**. Mr. Chairman, very briefly, I think that we have several issues that we would like to focus on which apparently are going to be points that are in somewhat dispute as we look at the reauthorization process. I know that you and I had discussed the fact that while we don't have a legislative vehicle before us today, the Commission has made a proposal—which I think many of us are familiar with—and that perhaps through this process of oversight and reauthorization hearings, that we might be facilitators in trying to bring about resolution to several of the contentious issues that seem to still be with us. But by and large, this is a—compared to previous reauthorizations—rather mild session, I would think.

In that regard, I would like to have those who will be participating in the hearings, and perhaps resolving some of these issues, to know that we are going to wait until we are through with these hearings before we introduce legislation which will serve as a markup vehicle. And hopefully, by that time, some of these forces will come into play.

That's about all I have to say, Mr. Chairman, and I do look forward especially to information that we might glean from these hearings because it is a very complex subject and one which we have all the experts in the field, I think, before us in the next 2 days. And I know that it will be an interesting process.

Thank you very much.

Mr. **Jones** of Tennessee. Thank you very much.

And now I yield to Mr. Glickman for whatever statement he might like to make.

OPENING STATEMENT OF HON. DAN GLICKMAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF KANSAS

Mr. **Glickman**. Thank you, Mr. Chairman.

I want to first of all thank you for the fact that, I believe, over the last couple of years we've held at least three hearings on the CFTC. One had to do with general oversight; one had to do with ag options out in Kansas; one had to do with leverage, and I appreciate your leadership and your interest in this issue.

I have introduced some legislation, Susan, which deals with the leverage issue. I am very interested in that and I hope that you will address that in your statement, as I think the Commission has adopted a position similar—not identical, but similar—to the bill that I have introduced. I assume that you will be talking about the audit trail issue and other issues of current conflict between the Commission and the futures industry, and so I won't have too much more to say about that.

I would just make one final comment, though. I have great respect for you and all the Commissioners. I think that you are truly trying to do an excellent job during a very difficult period when the industry is changing so rapidly. We have all sort of sophisticated financial instruments, currencies, options that we had never dreamed of before.

I would kind of give you a little bit of an admonition. I've talked to you about this, though, that there is at least some fear that the Commission kind of goes from one extreme to the other in how it views itself and how it views its relationship with the industry, all the way from being too soft to being too tough, and kind of—a little bit of a ping-pong ball between the two. And I think maybe this has to do with the fact that you're fairly new in the industry, fairly new under regulation.

We want to see a strong industry, a flourishing futures industry. We also want to see strong Government protection of the consumer and the taxpayer, and I would urge you that in your dealings with the industry, that you be aware that there is a feeling in this country that maybe you're not as consistent—"you" being the Commission, not you personally—in the way you apply rules and the way you deal with the public and with industry, as you should be. And I suppose the final admonition is, you're the Government; act like it, which doesn't mean you shouldn't be unfair but it should mean that you need to realize that you have the full weight of the Congress and the people behind you.

Thank you, Mr. Chairman.

Mr. JONES of Tennessee. Thank you very much, Danny, for your statement.

And now, I yield to Mr. Gunderson for any statement he might make.

OPENING STATEMENT OF HON. STEVE GUNDERSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WISCONSIN

Mr. GUNDERSON. Thank you, Mr. Chairman.

As we begin this process, I think many in the room would enjoy an analogy which just came to my mind. I can't believe, in my young service in this Congress, that I am already into my second reauthorization of the CFTC. It's sort of like initiation into a college fraternity; everybody ought to have the experience of going through it once, but I'm not sure anybody should go through it twice. [Laughter.]

And I say that not because of any lack of interest in the issues, but rather I think that as we look at some of the compelling issues which are in front of us—on the one hand, I think we have, perhaps, less controversy and acrimony than we did 4 years ago when the whole question of the Futures Association was confronting us and what their role should or should not be; but I think also we need to recognize that there are a couple areas where we still have potential for major controversy. Obviously, these include the leverage issue, as mentioned by Mr. Glickman; the audit trail issue; again, the continuing role or conflict between the CFTC and the NFA. And I only bring these up to those of you who are here because it seems to me that, due to the complexity of the issues involved in the Commodity Futures Trading Commission, it is absolutely essential that we make every effort in our subcommittee and in the full committee to resolve these issues. Frankly, the issues are too complicated to be debated and played out in a political game on the floor of the House. You have to study these issues night and day to have any working knowledge and understanding of them, and I would hope that we would not play some kind of a hardball political game on the floor of the House and determine what are very, very important public policy statements.

So let's make that the goal of this whole reauthorization process in our subcommittee, Mr. Chairman. Thank you.

Mr. JONES of Tennessee. Thank you very much, Steve, for those kind remarks. I have noticed that the chairman of the full Agriculture Committee is present, and I'd like to recognize Mr. de la Garza at this point.

OPENING STATEMENT OF HON. E (KIKA) de la GARZA, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

The CHAIRMAN. Thank you, Mr. Chairman. I don't want to interrupt the proceedings.

I welcome Ms. Phillips and the other members of the Commission that might be here, all interested in this industry and what we do here.

Mr. Chairman, I hope that at the end of your hearings, once we've heard all of the witnesses and we've gone into basic legislation, I'd like us to have some time in basic oversight, on the structure of the Commission and who does what. I know they send us that in their annual reports, but we ought to have something in the record and public.

And with that, I welcome all of our friends and I thank you, Mr. Chairman.

Mr. JONES of Tennessee. Thank you very much, Mr. Chairman, for being here, and we will certainly observe the suggestions that you've made at the right time.

Mr. Cooper Evans, you are recognized.

Mr. EVANS of Iowa. Thank you, Mr. Chairman. I don't have any real opening remarks, but I would like to take note of the fact that Chairman Susan Phillips is a constituent of mine, and to take this opportunity to welcome her back before the committee and to tell her that I look forward to her statement and to these hearings, with the subsequent legislation to reauthorize the CFTC.

Thank you, Mr. Chairman.

Mr. JONES of Tennessee. Thank you very much, Cooper, for that fine statement.

Mr. Sid Morrison.

Mr. MORRISON. Thank you, Mr. Chairman, just to say that I've enjoyed—since the time we've gone through reauthorization a few years ago—I've learned much, much more about the operation of the Commission and the commodity futures trading process itself, and so I hope to be able to make a greater contribution, and feel that we have a most interesting and vital subject area to work through these subcommittee hearings.

Thank you, Mr. Chairman.

Mr. JONES of Tennessee. Thank you, Sid.

I notice that we have the presence of another former member of the subcommittee, and certainly still a member of the full committee, Glenn English. Glenn, do you have any statement that you'd like to make?

OPENING STATEMENT OF HON. GLENN ENGLISH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OKLAHOMA

Mr. **English**. Thank you, Mr. Chairman, simply to say that I am hopeful that we'll have the opportunity this year to have an uneventful reauthorization of CFTC. I think that we have finally reached that point in which we have seen a maturing of the CFTC, and certainly, greater cooperation between CFTC and the industry to the good of the public at large.

The NFA was a new organization when we looked at reauthorization last. We told the industry at that time that they could take their choice between becoming a part of a strengthening of oversight of this industry, a self-regulation if you will, and to assist the CFTC in their work; or that we would likely, in the future, be looking at user fees, as many people were advocating back during that period.

I'm delighted to report that the CFTC has, of course, told us that NFA has made significant contributions. They have, in fact, been very cooperative, very helpful, and we do have a better industry because of the work of the NFA. I think that for all those who would advocate self-regulation, that certainly the NFA is an example that will be held up in other segments of Government.

But I think it's still important to recognize that there are those, Mr. Chairman, who are not as enthusiastic as we, and there are those who, I think, would like to see the CFTC done away with, quite frankly, and it be regulated by other means. And so I think that it is important for the industry and for the CFTC to join together and to once again demonstrate to this country that they can, in fact, do an admirable job of regulation.

I appreciate being allowed to be here today, Mr. Chairman. Thank you.

Mr. **Jones** of Tennessee. Thank you very much, Glenn, and I do sincerely appreciate your continued interest in the subject matter that this subcommittee deals with, and tell you that we do miss you off this subcommittee. We appreciate your attendance here today.

Before we hear from the Chairman, I'd like to introduce two other members of the CFTC who are here this morning: Kalo Heineman—Kalo, we appreciate you very much, and we appreciate your attendance today; and Fowler West is also in the audience. Fowler, we appreciate your being here.

I believe that's all the members of the——

Ms. **Phillips**. Commissioner Davis is also here.

Mr. **Jones** of Tennessee. Commissioner Robert Davis? I'm sorry; I didn't see you. Will you be recognized?

Thank you, sir. Thank you for being here. Anyone else, Susan?

Ms. **Phillips**. No.

Mr. **Jones** of Tennessee. OK.

All right. Now we'll get on with the business of the day and hear our first witness; all of you already know who she is, the Chairman of the Commodity Futures Trading Commission, the Honorable

Susan Phillips. Susan, welcome, and you may proceed. If you have additional information that you want to file without referring to it, you may do so.

STATEMENT OF SUSAN M. PHILLIPS, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION, ACCOMPANIED BY KALO A. HINEMAN, COMMISSIONER, FOWLER C. WEST, COMMISSIONER, AND ROBERT R. DAVIS, COMMISSIONER

Ms. PHILLIPS. Thank you, Mr. Chairman, members of the committee.

I am pleased to come before you today representing the Commodity Futures Trading Commission to present our reauthorization proposal. Our request is brief. We are proposing what we believe to be minor changes to the Commodity Exchange Act, unlike the requests that were made in the sunset reviews of 1978 and 1982. Major revisions to the act were made in those years, and the Commission simply does not see the need for such changes at this time.

With your permission, I would like to submit two items to the subcommittee to be included in the record. The first item being a full, complete statement which details our experience with the amendments that were made to the act in 1982, as well as discussing some of our recent regulatory issues. And the second item is the Commission's explanation of its legislative request.

Mr. JONES of Tennessee. Without objection, that will all be made a part of the record.

Ms. PHILLIPS. Thank you very much, Mr. Chairman.

The legislative changes that we propose have been submitted to the subcommittee and are the same as those contained in S. 2045. Our legislative package is comprised of four parts that deal with enforcement and appellate review matters, leverage transactions, registered futures associations, and several miscellaneous amendments. I'd like to begin with a brief description of the Commission's proposals in the area of enforcement and appellate review.

One of our proposed amendments would alter section 4b of the act, which generally prohibits cheating or defrauding in connection with any contract or sale of a commodity for future delivery made "on or subject to the rules of any contract market." The Commission is concerned that the current language of section 4b may be interpreted narrowly to limit our authority to exchange-traded futures, resulting in a court's refusal to apply section 4b to the sale of off-exchange futures contracts. The amendment would not expand the Commission's jurisdiction, nor would it in any way reduce the authority of the States to move against off-exchange fraud operations. This amendment would simply make clear that both the Commission and the States have the authority to prosecute fraud committed by off-exchange futures operators.

Our second proposal in the area of enforcement would amend section 6(b) of the act expressly to authorize the Commission to serve investigatory and other administrative subpoenas on persons outside the territorial United States. We believe the proposed change is necessary in light of a recent decision of the U.S. Court of Appeals for the District of Columbia Circuit. The court ruled that section 6(b), as presently drafted, does not authorize enforcement of an investigatory subpoena served on a foreign citizen in a foreign country. The appeals court did not question the authority of Congress to so authorize the Commission, but rather ruled that Congress had not granted such authority when it enacted section 6(b).

The Commission believes that its investigatory capability may be seriously compromised by this decision and requests an amendment to 6(b) clarifying that investigatory subpoenas can be served on U.S. market participants, even though they are outside of the territorial United States.

Our third enforcement proposal, the Commission requests statutory authority to seek the ex parte appointment of a receiver when it seeks an ex parte freeze of a firm's assets. Section 6c of the Commodity Exchange Act authorizes the Commission on an ex parte basis to obtain a restraining order to freeze the assets of persons it believes have engaged in, or are about to engage in, a violation of the act or Commission rules, and to prevent such persons from destroying books and records. As the section is presently written, however, there is no express power for the court to appoint a receiver on an ex parte basis to protect and manage the business of the firm subject to the freeze order.

Often, the period between the issuance of the ex parte restraining order and the hearing on the application of a receiver may be as long as 15 to 20 days. During that time, the restrained operation may hold open positions in the futures markets that would go unmanaged. In addition, while the assets are frozen, employee salaries may go unpaid and employees may quit, further limiting the ability of the operation to preserve any assets on behalf of customers. A temporary receiver could pay salaries and other legitimate expenditures, meet margin calls, or liquidate unprofitable positions and otherwise protect the assets of the operation for the ultimate distribution to customers.

In the area of appellate review, the Commission proposes to add a new section to the act to allow persons aggrieved by a final Commission order or rule to obtain review of that order or rule only in a U.S. court of appeals. If adopted as drafted, the amendment would eliminate the current two-step procedure that permits an appeal to begin in a U.S. district court.

In the course of issuing many of its final orders and rules, the Commission employs a number of administrative procedures which, in many ways, are analogous to the function of the district court in gathering and weighing evidence in disputed matters. Review by a court of appeals would provide for a definitive ruling more promptly and save judicial and Commission resources, as well as the resources of the aggrieved party.

The second part of our legislative package would eliminate the Federal regulation of leverage transactions under the Commodity Exchange Act.

Because off-exchange trading is not subject to self-regulatory oversight and has been associated with allegations of fraud and high-pressure sales resulting in numerous customer complaints, Congress and the Commission historically have been concerned with off-exchange instruments and have proceeded cautiously in this area. The Commission's comprehensive leverage regulations have been in effect since April 1984, although the regulations were phased in over a period of time. Under the Commission's moratoria on new firms and new products, two firms are currently operating as CFTC-registered leverage transaction merchants. The application of one other firm is currently before the Commission.

In developing its leverage recommendation to Congress, the Commission considered two other feasible alternatives: first, retaining the current moratoria, and second, lifting the moratoria on new entrants and products to the leverage business, provided that certain regulatory responsibilities are assumed by NFA. While there was some support on the Commission for the second alternative, the Commission ultimately voted to recommend the elimination of leverage regulation by the CFTC.

This recommendation reflects the Commission's concern with the expansion of off-exchange instruments and the required commitment of resources, which could be dedicated otherwise to overseeing the futures industry.

Recognizing the potential effect on the two existing regulated firms, the Commission could, by taking a no-action position, allow time for these firms to adjust their businesses to conform to State regulatory structures—most likely under the Model State Commodity Code that many States are currently considering. These firms could establish businesses offering commodities on some kind of cash and carry basis or installment purchase; or, for that matter, they could reorganize and apply as an exchange.

In sum, the Commission believes that the sale of futures contracts should occur on exchanges under the supervision of self-regulatory organizations. Adoption of this recommendation would eliminate what the Commission perceives as the historical and unjustified distinction between leverage and futures contracts.

The third part of the Commission's legislative package presents our recommendations on the activities of the National Futures Association. As you mentioned, Mr. Chairman, the Commission submitted its report on the regulatory performance of the NFA to Congress on January 1, 1986. The Commission generally concluded that NFA has succeeded in meeting its mandate to adopt and, with certain exceptions, to implement a comprehensive self-regulatory program in the public interest. Our recommendations with respect to NFA came out of this report. They should enhance both NFA's effectiveness as a self-regulatory organization and the Commission's ability to fulfill its oversight responsibilities.

First, the Commission proposes to amend section 17(h) to make the automatic stay provisions of that section inapplicable to NFA disciplinary actions, including member responsibility actions. The effectiveness of any sanctions imposed as a result of formal NFA disciplinary procedures are likely to be diminished if a suspended or expelled member can forestall the result merely by filing an appeal with the Commission. This amendment would make the stay provisions of NFA's member responsibility actions parallel to those of exchange disciplinary actions.

In related matters, we propose to amend section 17(i) expressly to authorize the Commission to review only the record before NFA and the submissions of the parties. We propose to amend section 17(i)(3) to make the standards for Commission review of an NFA decision to deny membership, or association with an NFA member, similar to the standards applied to NFA disciplinary actions.

Further, in order to facilitate the Commission's continuing oversight of the National Futures Association and its implementation of key self-regulatory functions, the Commission is proposing to amend section 17(k) to make the Commission's authority to alter or supplement NFA rules parallel to, and no less broad than, the Commission's comparable authority with respect to the rules of contract markets.

Another of our proposals addresses the disparity in the statutory procedures for Commission review and approval or disapproval of new rules proposed by NFA and the exchanges. Maintaining two different rule approval procedures imposes an operational and administrative burden on the Commission. We therefore propose that the NFA rule review process be made consistent with the similar provisions governing other self-regulatory organizations.

The fourth part of the Commission's legislative package proposes changes to section 9(d) of the act, which would give the Commission the authority to make appropriate changes to its standards for permissible investments by Commission personnel in recognition of the vast array of commodities on which futures contracts are now traded.

As a final proposal, the Commission seeks reauthorization for 6 years, until the fiscal year ending September 30, 1992. The Commission has been fortunate to have the active interest and ongoing oversight of this congressional subcommittee. We welcome your continued direction and oversight until our next reauthorization.

Mr. Chairman, I'd be pleased to answer any questions from the subcommittee; or later for the record, since I'm first up this morning, and other issues may come before the subcommittee.

[The prepared statement of Ms. Phillips appears at the conclusion of the hearing.]

Mr. JONES of Tennessee. Thank you very much, Susan. Are you going to be able to be with us for the morning?

Ms. PHILLIPS. Yes, sir. This morning? Yes.

Mr. JONES of Tennessee. And this afternoon, too?

Ms. PHILLIPS. I can, if you would like.

Mr. JONES of Tennessee. Well, it might be necessary. I think the members of the subcommittee would desire that, if you can stay with us.

Ms. PHILLIPS. Certainly.

Mr. JONES of Tennessee. OK. I think while she's at the witness table, this would be an appropriate time for members of the subcommittee to ask the chairman any questions they might like.

Mr. Coleman, do you have a question?

Mr. COLEMAN. As soon as Susan is getting her voice back.

Mr. JONES of Tennessee. Don't feel bad, Susan; the country is full of it right now. [Laughter.]

We all have the same problems.

Ms. PHILLIPS. I appreciate your concern. Thank you.

Mr. COLEMAN. Let me ask a few questions about your leverage proposal. My questions should not be interpreted as being supportive or opposing it, but actually to find out some information.

Ms. PHILLIPS. Yes; it would. If they take it voluntarily, they could take it over.

Mr. COLEMAN. But if they objected to it, then it would require legislation?

Ms. PHILLIPS. Yes, sir.

Mr. COLEMAN. All right.

Are complaints on the rise, or on the decline, or staying the same on these leverage transactions?

Ms. PHILLIPS. In absolute numbers terms, they are declining; but so are total complaints. So, as a proportion, it's remained fairly constant, about 11 percent of our complaints.

Mr. COLEMAN. Mr. Chairman, my 5 minutes are up. I assume we'll go around again?

Mr. JONES of Tennessee. We will. Yes, sir. Thank you, Mr. Coleman.

Now, Mr. Glickman, you're recognized.

Mr. GLICKMAN. Thank you, Mr. Chairman.

Susan, I'd like to get the position on leverage focused, if possible. Is it your position that leverage contracts be regulated as futures contracts?

Ms. PHILLIPS. Over a period of time in our regulatory oversight, the Commission has come to see these contracts as being indistinguishable from futures contracts. So yes, in that sense, that would be the case.

Mr. GLICKMAN. I'm trying to determine what factors led you to reach this conclusion, that they were in fact—what you're basically saying is that leverages are futures, and I'd like to know how you made that basis.

Ms. PHILLIPS. Essentially, long-term futures contracts. The major difference, of course, is where they are traded. Futures contracts being traded on an exchange have a clearinghouse environment; that's a major difference, because leverage contracts are issued by the dealer or the leverage firm. So from a customer's point of view, in order to offset that contract, that customer must go back to and depend on that dealer whereas, in futures contracts, the clearinghouse takes the opposite position.

Mr. GLICKMAN. Now, your recommendation, basically, is going to end this leverage monopoly where we have two firms in business that basically have been grandfathered under a law that we passed in 1982. I take it you believe that's a better course than allowing those two firms to continue selling leverage indefinitely? If so, why? Also, how do you respond to the argument that we are disenfranchising two existing businesses?

Ms. PHILLIPS. In looking at the way the two firms market their products, much of their customer base, of course, is for long-term purchase or sale of the commodity. So to the extent sales appear to be similar to a long-term installment kind of business, it seemed to us that they should be regulated or supervised like any other kind of installment sale kind of arrangement. So, it is because of the familiarity that we have developed with the industry through the regulatory process that we came to this recommendation.

Mr. GLICKMAN. Do you think, though, that they will be able to cope with this by altering or modifying the way they do business, to comply with State laws, though?

Ms. PHILLIPS. We do believe so. Alternatively, I think in a fashion similar to what your legislation contemplates, they could be traded in an exchange environment.

Mr. GLICKMAN. OK.

Let me move on for a moment to the issue of the audit trail. Can you tell me what the status of the audit trail requirements are or is? Also—I understand the Office of Management and Budget has now entered the picture on this issue, and I wonder if you might outline that for the committee.

Ms. PHILLIPS. Yes. In mid-January, the Commission did pass its final rule in the audit trail area. The rule is a very general rule; that is to say, it is a goal, a standard, and it does require that all transactions be recorded on the trade register in increments of no more than 1 minute.

It does allow exchanges a variety of ways in which to come into compliance. It does not become effective until October 1. Now, we've asked exchanges to tell us how they are going to come into compliance in July, and it goes into effect in October. So the exchanges are, of course, in the process of determining how they plan to come into compliance right now.

Several of the large exchanges have pursued the development of a computerized trading or surveillance monitoring tool called the CTR, the Computerized Trade Reconstruction system. Because it is a complex, computerized system, the exchanges—I believe appropriately—have decided to get to work early on it, and have sought our opinion, so to speak, on whether or not it will comply. They submitted to us and made generally available to the public a description of the CTR system. I might say that all of the Commissioners, really within the last several weeks, have seen demonstrations of the system, and have been in contact with the staff people of the exchanges to find out what the system will do and find out what it won't do, and so on.

Based on these representations and our understanding of what it is supposed to do, we have indicated to them that we believe that it has the capability of meeting the requirements of 1.35g.

Now, I guess that's the first part of your question.

Mr. GLICKMAN. Mr. Chairman, I'd ask that Susan be permitted to finish the answer to the question.

Mr. JONES of Tennessee. Without objection.

Ms. PHILLIPS. OK. I'm sorry for being so long winded, but this is, of course, a long process.

The second part, you asked about OMB. It is true that the Office of Management and Budget has notified us that it wishes to review this rule from a paperwork reduction point of view, and OMB staff has initiated such a review. I would say this is the kind of thing they do, fairly regularly. It does not, of course, impinge on the implementation of the rule; the rule still goes into effect, and so on.

We, of course, intend to cooperate with OMB in its review. I think it's going to be very difficult for them to perform a review at this stage because the exchanges really haven't determined how, in some instances, they're going to come into compliance. So I suspect that the review will depend on how far along some exchanges are. It will affect the review as to its completeness.

Mr. GLICKMAN. Thank you.

Mr. JONES of Tennessee. Thank you very much, Dan and Susan.

Mr. Gunderson, you are recognized.

Mr. GUNDERSON. Thank you, Mr. Chairman.

Thank you, Susan, for your statement and for being here today.

You've talked a little bit about this leverage issue and you've talked about your proposal to really just simply eliminate section 19. As you know, the Glickman bill, of which I'm a cosponsor, deals with it in a different perspective by simply putting them on the exchange.

Could you comment directly on the alternative which Mr. Glickman has offered? Is it acceptable, in your opinion, as a course for us to follow?

Ms. PHILLIPS. We actually think that that proposed bill accomplishes the same thing as we are proposing. So in that sense, we are encouraged that you have put it forward because it does coincide with our intent.

I believe, however, that the way we have gone about it—I suppose one of the advantages of it—is that it will eliminate the anomaly that currently exists with respect to leverage versus futures. We seem to spend a lot of our time explaining the difference between leverage and futures. Since we don't see them as being legally or economically different, the Commission is recommending eliminating that distinction. But again, I do think they accomplish the same end.

Mr. GUNDERSON. A bit of a philosophical question, if I could. In your opinion, are leverage contracts sold only to speculators and not hedgers? Or would you say they're sold to both?

Ms. PHILLIPS. Since we have put the leverage regulations into place, the leverage firms do submit to us certain kinds of reports and information. One of the categories that is required for their customers is a category of commercial versus noncommercial. There have been no commercial customers. I suppose someone could fill out the form and say that they're noncommercial and be using it for hedging purposes, but ordinarily noncommercials are generally thought to be—or assumed to be—speculators.

Mr. GUNDERSON. All right. Here's my philosophical question, then. In your opinion, should the Federal Government permit futures trading that is solely speculative, or should there be some type of economic purpose of hedging required as part of the rationale for that?

Ms. PHILLIPS. Ours is the Federal agency that traditionally oversees a certain economic function in this country with respect to risk transfer, assumption, and rearrangement of price risk. We are really set up and have always traditionally been an agency to protect the integrity of those particular kinds of markets. So while a speculative market may be quite permissible, that may not be consistent with the notion of CFTC regulation of these instruments.

Mr. GUNDERSON. You didn't mention it in your oral statement, but one of the issues that certainly those of us who have been looking at the whole discussion of reauthorization brought forth is the possibility of increases in the net capital requirements for the Futures Commission merchants and the whole issue of customer account insurance. I think these deal with a couple of cases which you are familiar with.

Does the Commission have any recommendations from the legislative perspective on these issues?

Ms. PHILLIPS. No, sir; we do not. With respect to capital, that is a regulatory proposal that, in fact, is currently out for comment. We have made a proposal, and we have extended the comment period several times. We understand that several industry groups are contemplating submitting some alternative approaches to capital. So I see that as a regulatory issue that is very much in process at the current time.

With respect to insurance, which was the second part of your question, we did a preliminary study of whether or not insurance might be an appropriate additional customer protection feature that we would seek. Our study, however, really looked at the incidence of loss over a period of time and really did not assess either the cost of providing such insurance or explore specifically various approaches to doing so. Because, obviously, the FCM community would be major participants in that, we sought the assistance of the National Futures Association and asked them to do a more complete study. They have been engaged in that study for about 6 months, now, and in fact recently submitted a very preliminary report to us. But they are currently still in the process of engaging in that study. So there are no recommendations at this time.

Mr. GUNDERSON. Thank you.

Thank you, Mr. Chairman.

Mr. JONES of Tennessee. Thank you very much, Mr. Gunderson.

Mr. Stenholm, you are recognized.

Mr. STENHOLM. Thank you, Mr. Chairman.

In following up, Chairman Phillips, I would say in regard to the question of Mr. Glickman and also Mr. Gunderson, that the decision that you and your fellow Commissioners have made regarding the audit trail and the leverage question has met with considerable approval with the Texas Securities Commission, those who have followed your work in that line, and there is some considerable support for that.

The question that I would like to ask of you today is concerning agricultural options. As far as I know, the 2-year-old Agricultural Options Program has been an unqualified success. The volume figures have been relatively good and no regulatory problems have developed. Given this record, do you think the program should be expanded and its pilot status dropped?

Ms. PHILLIPS. I guess you've really asked me two questions there.

First of all, I certainly agree with you that it has been a success, and we have not incurred any regulatory difficulties. We have scheduled for Commission consideration within the next 2 weeks an expansion of that program. Several entities, including the wheat growers and the Chicago Board of Trade, have petitioned us to expand that program, and we will be acting on that—considering that petition within the next 2 weeks. So, I think we are moving forward in that area.

Now, as to whether or not the pilot program should be lifted, I think the Commission would not have an objection to doing that. We are not seeking it. It is not part of our legislative package, but I don't believe that we would object to it.

Mr. STENHOLM. Switching over to the subject of speculative limits, the CFTC set speculative limits on agricultural commodities. We know that those limits have not been increased in many years. I was wondering whether you have given any consideration to increasing the limits commensurate with changes in the agricultural economy?

Ms. PHILLIPS. I will say that it does come up periodically, and we have reviewed it. I would say particularly in the grains, for example, volume in the futures has not increased as rapidly as might be expected, and I think volume is really a market function. It's been a function of prices, and I think this committee is clearly aware of that situation. Because the volume has not increased as rapidly, we have not given recent consideration to it; and, in fact, we have been watching fairly closely a number of the expirations of some contracts because a lot of the stored grains, for example, are tied up in Government programs. And so tightness at delivery can occur.

We have not seen a need to increase those limits at this time, but it is something that we do continually monitor. We would be willing to reconsider should a petition come before us.

Mr. STENHOLM. One followup question concerning the leverage question—or rather, the audit trail question.

You indicated in a previous answer today—or referred to the audit trail or the standards as being a performance standard. Does this mean that exchanges will not be liable if they fail to capture trade times as described under the new law? In light of the OMB answer you also gave?

Ms. PHILLIPS. The audit trail requirement of a 1-minute standard is truly a standard. It is a goal. Now, clearly, with respect to how successful the exchanges are in capturing that data, that's a compliance kind of question. So in terms of actually capturing that data, I think we are looking to them to capture as best they can, and we'll have to measure and see how close they are able to come.

As you may know, we have previously had requirements that they record data within one-half hour periods. And we went back in to audit that, and we did find error rates of 30 to 40 percent. So clearly, there is discretion in enforcement. I think what we will be trying to look at is to see how close they come. Are their systems capable of capturing that kind of information? Clearly the proof is going to be in the pudding with respect to how well these systems perform.

Mr. STENHOLM. Thank you, Mr. Chairman.

We will be able to submit additional questions in writing for the record?

Mr. JONES of Tennessee. Yes; you will. And we'll go around again, if you're here. Thank you, Mr. Stenholm.

Mr. Cooper Evans, you are recognized.

Mr. EVANS of Iowa. Thank you, Mr. Chairman.

I would like to pursue something that you just touched on and that the gentleman from Texas raised in a different context, and that's the problem of delivery points and the availability of storage against delivery on grain contracts. And your very brief reference that a good bit of that storage was taken up, I think, with Government grain in Government programs.

In your judgment, is there adequate storage available at delivery points on the grain contracts to assure orderly liquidation at this point? Available for deliverable stock?

Ms. PHILLIPS. Certainly, we don't have any concerns with the available storage facilities. Now, whether or not the grain that is stored is available for delivery really depends on the commitments of either producers and/or exporters. So you can have tightness that occurs periodically. I think it is something that bears continual monitoring, and it's something that we're continually looking at. But we don't see it as a problem at this point that needs immediate correction.

Mr. EVANS of Iowa. Have you looked at all at the storage charges for grain in the official delivery warehouses, compared to storage charges at other points across the country?

Ms. PHILLIPS. Yes; we have had some inquiries to look into, particularly, the storage facilities in Chicago and the load-out rates for those facilities.

Mr. EVANS of Iowa. I've been told, and I don't know this to be a fact, but I've been told that it costs you something like $.60 a bushel a year to store grain in the official delivery terminals, which is roughly twice the commercial rate across the country. If that is so, why would there be substantial amounts of Government grain stored in those facilities at twice the going commercial rate?

Ms. PHILLIPS. I think it's a question of what happens to be there at the time and what the commitments are. And some of it's not Chicago, of course; Detroit is also a delivery point.

Mr. EVANS of Iowa. It seems to me that that's an area that needs some consideration. I have, on occasion, inquired about whether it was possible to place grain in a position to deliver, and then not been able to find any space. Now I'm told that the Government has a lot of that space occupied with grain and paying twice the conventional customary rates across the country. I don't know whether that's true or not, but it just seems to me that this is an area that needs some examination. And, of course, as we go through the reauthorization hearings, invariably various members have desires to attach requirements for you to study in some area or other, and I took advantage of you the last time, I think, in that particular respect.

I wonder how you would view a mandate to examine this question in connection with reauthorization this time around.

Ms. PHILLIPS. Certainly, if course, we'd be glad to look at it. And what I guess I would offer, if at this point it would be helpful, we would be glad to look into it immediately and submit some additional——

Mr. EVANS of Iowa. No; I don't want to impose a study that has no merit on the CFTC, but it seems to me that there are some areas here that are of concern, and I would appreciate some advice from you before we get to the markup stage on your views—not necessarily the industry's views—on the merits of such a study.

Ms. PHILLIPS. I'll be glad to submit some additional material, Mr. Evans.

[The material follows:]

Capacities of Warehouses Filing Reports for CFTC Weekly Stocks of Grain Reports

Response to Questions of Honorable Cooper Evans

The figures below indicate capacities registered with the Chicago Board of Trade ("CBT") for elevators regular for CBT deliveries in the Chicago, Toledo, St. Louis, and Minneapolis areas. These figures are based on Appendices 10A, 10B, 10C, and 10D of the Rules and Regulations of the Chicago Board of Trade. The CBT's licensing period is for one year beginning July 1, 1984. The Secretary's office of the CBT was contacted to review the information published in the CBT rule book.

(a) Chicago Area (wheat, corn, soybeans, oats)

Elevator		CBT-Regular Capacity (bu.)
Cargill at Burns Harbor		5,473,000
Cargill Elevator		20,460,000
Continental "B"		9,188,000
Continental "C"		6,750,000
Rialto (General Mills)		2,750,000
Gateway (Indiana Farm Bureau Coop.)		7,795,000
	TOTAL	52,416,000

The total CBT-regular capacity for the Chicago regular elevators is unchanged from the total as of December 31, 1983.

(b) Toledo/Maumee Area (wheat, corn, soybeans)

Elevator		CBT-Regular Capacity (bu.)
The Andersons - Maumee		18,190,000
The Andersons - Toledo		7,000,000
Cargill - Maumee		6,261,000
Cargill - Toledo		6,212,000
Mid-States		8,000,000
	TOTAL	45,663,000

CBT-regular capacity in the Toledo/Maumee area declined from 51,686,000 bushels licensed as of December 31, 1983. According to Kris Kula of the CBT Secretary's office, Agra Land elevator was unable to meet financial requirements for renewal of its 5,500,000 bushel capacity. In addition, Cargill's Toledo elevator registered 6,212,000 bushels rather than 6,735,000 bushels which were registered as of December 31, 1983.

(c) St. Louis Area (corn)

Elevator		CBT-Regular Capacity (bu.)
Continental		2,500,000
Growmark, Inc. - Elevator A		2,225,000
	TOTAL	4,725,000

The total CBT-regular capacity for the St. Louis area declined from 8,290,000 bushels as of December 31, 1983, as Peavey did not apply for regularity on its elevator. Peavey had previously registered 3,560,000 bushels. Furthermore, Growmark reduced the regular capacity at Elevator A by 5,000 bushels.

(d) Minneapolis/St. Paul Area (oats)

Elevator	Operator	Location	CBT-Regular Capacity
Port Cargill Elev C	Cargill, Inc.	Savage	17,603,000
Port Continental Elev	Cont'l Grain Co.	Savage	5,402,000
Port Bunge	Bunge Corp.	Savage	11,919,000
Pillsbury A Elev	Pillsbury Company	Mpls.	3,500,000
Harvest States 1 & 2	Harvest States Coop.	St. Paul & Mpls.	7,900,000
Washburn Elev	General Mills	Mpls.	5,625,000
Electric Steel Elev	Peavey Company	Mpls.	3,700,000
Checkerboard Elev	Ralston Purina Co.	Mpls.	2,400,000
Soo Elevator	ADM Grain Co.	Mpls.	3,610,000
Elevator D	ADM Grain Co.	St. Paul & Mpls.	16,480,000
Shoreham Elev	ConAgra, Inc.	Mpls.	3,193,000
Honeymead Elev	Harvest States Coop.	Fridley	2,800,000
Harvest States	Harvest States Coop.	Savage	565,000
		TOTAL	84,697,000

CBT-regular capacity in the Minneapolis/St. Paul area declined to 84,697,000 bushels from 88,930,000 bushels on December 31, 1983. ConAgra did not renew regularity on its Pioneer Steel elevator and Belco 5 elevator with previously registered capacities of 1,880,000 bushels and 2,353,000 bushels, respectively.

The CBT-regular capacities as shown above for each area are currently indicated on CFTC "Stocks of Deliverable Grains" report. Thus, no changes are required in regular capacity figures published on that report.

Mr. EVANS of Iowa. One brief question, since we just have a few seconds left.

What is the judicial branch of Government's attitude toward going directly to the appeals court and passing over the district court?

Ms. PHILLIPS. Well, a number of other regulatory agencies already have that capability; and in fact, most regulatory agencies' actions are appealed directly to the appeals court.

Mr. EVANS of Iowa. So you think they have no objection?

Ms. PHILLIPS. We have not polled all district courts, but it is a common practice.

Mr. EVANS of Iowa. Thank you.

Thank you, Mr. Chairman.

Mr. JONES of Tennessee Thank you very much, Mr. Evans, for your discussion.

Now the Chair recognizes Mr. Daschle.

Mr. DASCHLE. Thank you, Mr. Chairman.

I don't have a question with regard to audit trails; I think it's been adequately covered. I think we have to look at the practicality of the audit trail regulatory practice as we go through the next couple of years, and I think the impact statement that we're going to have is going to be a very important one in giving us an evaluation of how to work in the future. But I think we'll have to revisit it from time to time, and I applaud you for your willingness to adapt that regulation to the industry as it fits rather than to put one template across the whole industry and expect it to fit in each case, precisely the same.

I'd like to go back again, if I could, to the leverage question and to the differentiation, if any, that you see. You made the statement that there really wasn't any legal or economic difference between leverage contracts and futures contracts. There appears to be at least some difference, and I'd like you to elaborate, if you could.

The distinction of a 10-year life of a leverage contract, certainly, is one thing; leverage merchants participating in contracts is another. How do you view that? When you said there's no legal or economic difference, do you mean that precisely or do you mean roughly no difference? How do you view that?

Ms. PHILLIPS. From a customer's point of view, these are both contracts for the future delivery of a particular product, a specified amount at a certain point in time. And most futures contracts, of course, are for shorter periods of time.

So the length of time is a difference; but in terms of the generic nature of the contract, no.

Mr. DASCHLE. And you determined that the leverage contracts have to have at least a 10-year life, is that correct?

Ms. PHILLIPS. That's a good point. The reason that we set the definition at 10 years is that in going back through the legislative history of leverage, these instruments were always described as "long-term contracts." And there certainly was some mention, also, of the term "10 years." We wanted to draw a distinct or bright line for defining leverage contracts, legal leverage contracts, versus everything else because both the States and the CFTC, of course, can prosecute those things that are not legal leverage over which we currently have exclusive jurisdiction. So in terms of being able to give the States some help in trying to identify the kinds of operations into which they could immediately step for prosecution purposes, that's one of the reasons that we went that route.

Mr. **Daschle**. It seems to me—and correct me if I'm wrong—that the 10-year was somewhat of an arbitrary figure. Why not 9 years or 6 years? Could you give me a little more rationale? And then, in your answer, tell me why it wouldn't be in the merchant's interests, if he wants to be regulated, he sets it at something more than 10 years. If he doesn't—if he creates a 9-year contract—he's not subject to your regulation. That's the concern I have, and maybe you could address both.

Ms. **Phillips**. The first part really has to do with being able to identify what is legal leverage and what is off-exchange futures. Why 10 years? OK. There were continuous references through the legislative history to long-term contracts, and 10 years was, in fact, used as an example. So it's not something that we "picked out of the air."

Mr. **Daschle**. But in terms of the legal definition, it could be 5 years or—

Ms. **Phillips**. It could.

Mr. **Daschle**. You picked 10 years because of the example, is that it?

Ms. **Phillips**. Yes; we picked 10 to make it perfectly clear that these were to be long-term kinds of contracts, and to distinguish them very clearly for the public's use, to distinguish them from exchange-traded kinds of instruments. I think that that would be the reason.

Now, you indicated, what if they just wanted to avoid us and do a 9-year contract? Well, if it has the indicia of a futures contract, then they would likely see our enforcement people—or the State's enforcement people—knocking at their doors, because that would be viewed as an off-exchange futures contract, which would not be legal.

Mr. **Daschle**. If I could just follow up very briefly.

Since they're not really that distinguishable—futures and leverage contracts are very similar in every way, except for that 10-year distinction—you could have what is, in essence, a leverage contract for less than 10 years and, by the definition you've given us, these people could seemingly get off scot-free. I don't want to put words in your mouth, but you'd have to call that a futures contract in order for that to be regulated. But if they argue with you, no, that's a leverage contract, then it seems to me that if they're persuasive enough, that there's really nothing with which you could respond regarding your jurisdiction.

Ms. **Phillips**. If it is an off-exchange contract that has the indicia of a futures contract, it is something over which we the CFTC have the jurisdiction and would pursue in an enforcement action. The States also could.

Mr. **Daschle**. Thank you.

Mr. **Jones** of Tennessee. Thank you very much, Mr. Daschle.

And now, Mr. Jeffords, you are recognized.

Mr. **Jeffords**. Thank you, Mr. Chairman.

We've gone over many of the issues over and over. I want to say that I hope that on these issues—capital requirements and audit trails—you will be able to work with the industry. I'm pleased to see some indication that that will occur.

These are items that ought to be handled in a way that will be consistent with the industry's practices so that we don't have to get involved legislatively.

With respect to the leverage aspects, which is probably the only area that we will have to legislate, I'm somewhat concerned and confused about exactly what your intent to eliminate section 19 is and what you think would happen to the two institutions that would no longer be in the special category that they are now. What do you expect will happen to them?

Ms. PHILLIPS. We would anticipate that they could revise the contracts that they currently offer to make them more clearly installment sales, long-term installment sales, cash and carry kinds of sales of commodities. And in that situation, it would be just like any other commercial sale and would be subject to the State requirements. So that is what I would anticipate happening.

Alternatively, I suppose they could endeavor to become exchanges.

Mr. JEFFORDS. Well, then I'm a little confused—you don't think that they would attempt to qualify as futures?

Ms. PHILLIPS. If they decided to set up an exchange and have exchange-traded instruments, yes; then they would be called futures contracts, long-term futures contracts.

Mr. JEFFORDS. What is your rationale for not just opening up the moratorium and allowing others to compete in that area, subject to your regulation?

Ms. PHILLIPS. Well, I think that there really are a number of reasons. First of all, I think that the Commission has been—and Congress traditionally has been—very concerned about off-exchange instruments trading without the supervision of a self-regulatory organization. This has been an area that has been somewhat ripe for boiler room kinds of scam operations. In order to make it very clear to the general public that if you're investing in these kinds of contracts that are Federally regulated, they must trade on an exchange. The exceptions that have been granted in this area have been very narrow, and the Commission has pursued maintaining that narrow approach.

So in opening it up, so to speak, we are concerned that there would be a lessening of the availability of exchange protections and certainly, from our standpoint, there's a resource consideration. I think we are all looking for ways to try and do more with less; and in prioritizing what we believe to be the important mandates of the Commission, they are the protection of the futures markets. And so it is for that reason, or a series of those reasons, that the Commission voted to make this recommendation to Congress.

Mr. JEFFORDS. Suppose they were to come under the purview of, or work with, NFA. Would that change your view?

Ms. PHILLIPS. The Commission certainly did explore that, and there was clearly some support on the Commission for going that route. NFA has not, might I add, indicated a willingness to do this voluntarily, so it would take a statutory change. I think if we were to go that route, we would have to work with NFA to determine how specifically to lift the moratoria restrictions.

I see that as a viable, feasible alternative. It is not our primary recommendation.

Mr. Jeffords. Thank you.

Mr. Jones of Tennessee. Thank you very much, Mr. Jeffords.

Mr. Weaver, you are recognized for 5 minutes.

Mr. Weaver. Thank you very much, Mr. Chairman.

Chairman Phillips, I want to commend you for some very fine actions you've taken, and from what time I've been able to spend watching the CFTC, I think you're doing an excellent job.

I particularly commend you on your 1-minute rule. Could you tell us the status of that now? I know it's been kind of controversial.

Ms. Phillips. Yes, sir. I appreciate your comments about the Commission.

Yes, we did pass an audit trail rule in mid-January, and that rule goes into effect in October. And the exchanges have between now and July to tell us specifically how they plan to come into compliance.

So the exchanges, at this point, are developing their approaches to come into compliance. Some of them have come in at an early stage and discussed with us means of coming into compliance; in fact, several exchanges already have systems that would meet the rule.

Mr. Weaver. For the benefit of members who might not know the 1-minute rule, would you explain it, please?

Ms. Phillips. Yes, sir. What we have said is that the time of all transactions must be recorded on the trade register, which is the permanent recordkeeping requirement, in increments of no more than 1 minute.

Mr. Weaver. To make sure that perhaps a floor trader might not have gotten his own trade in there right before a customer, is one of the things it might look at, isn't it, under the 1-minute rule? So they could find out the close chain of sales? If floor trader Jones made a sale right before customer Smith got his sale in, that sort of thing?

Ms. Phillips. Absolutely. And that is one of the potential abuses that this rule sought to address.

Mr. Weaver. Again, I commend you.

Why not—I'm really not asking you this question; it's a policy question—but technically, why not ban broker-traders? Just not allow them to exist at all? I mean, you can either be a trader or a broker?

Ms. Phillips. The Commission has looked at that several times over its history and has rejected it, primarily because of the concern for the liquidity in the markets. And so, simply, the Commission opted to retain the capability for traders to trade both for their own accounts and for customers as long as there is an adequate audit trail. And such an audit trail, we believe, also will have a strong deterrent effect to prevent the kinds of abuses you have cited.

Mr. Weaver. I'd certainly commend and agree with you, that that would be a great help.

I don't think the argument of liquidity is valid, myself. The floor trading that goes on is generally—usually—simply to fleece the gullible public in these commodity pits, that are really dens of thieves or packs of wolves—you take your pick, Tom, either one. The floor traders actually spend most of their time trying to find the stops that the public has put in, and getting them, then sell into the public and, in effect, literally cream the small speculator.

Now, I'll have to admit. There should be a sign up saying, "Let the small speculator beware—free market at work." And in order to have a market, it has to be free.

But I'm going to be offering some amendments, Mr. Chairman, to this bill that will at least give the small speculator a chance—say, the farmer who is trying to hedge with a couple of contracts of soybeans or cattle—to give him a fighting chance. Right now he doesn't have one; 95 percent of the small speculators lose money for various reasons. But those include the farmers, and the farmer can be taken on a wide swing by these market manipulators who both manipulate the market by the minute and the hour, as well as by the week and the month.

And so these amendments will be addressing these areas. And the louder the screams from the dealers, the more justified the amendments. And they will include—if I might have 30 more seconds, Mr. Chairman—I'll just say that they would include banning the broker-trader; putting severe limits on floor trading, particularly by huge institutions that trade 10,000 contracts a day, selling in the morning and buying at night or buying in the morning and selling at night, or within a half an hour, to go these swings; and to put limits on such day trading; and have a full-time floor inspector paid by the exchange—by the CFTC; a floor inspector, which I do not believe you have now, Chairman Phillips.

Am I correct that you do not have a full-time inspector in the pit at all times, or am I wrong on that?

Ms. PHILLIPS. We do have surveillance people that are on the floors periodically——

Mr. WEAVER. Periodically.

Ms. PHILLIPS. During busy times, opens, closes. But not regularly.

Mr. WEAVER. I would like to have somebody there every single minute, and paid for by the exchange.

Chairman Phillips, again, thank you. Excellent work.

Mr. JONES of Tennessee. Thank you, Mr. Weaver.

Mr. Morrison, you are recognized.

Mr. MORRISON. No questions, Mr. Chairman.

Mr. JONES of Tennessee. The Chair will take his time and then we'll go around again, if no one objects.

Two or three questions, Susan. I believe this one has not been touched on yet.

Some of the exchanges have developed and entered into some international trading relationships with foreign exchanges. Can you give us an overview of really what's taking place in the international futures trading area?

Ms. PHILLIPS. Yes, sir. That is an absolutely burgeoning area. I think the only formal arrangement that we currently have on the books is a mutual offset linkage system between the Chicago Mercantile Exchange and the Singapore International Monetary Exchange, SIMEX, and that is a formal linkage. It is working quite well. It has not had an enormous amount of volume through it, but

I think that the exchange officials at both ends have been very satisfied.

I might say that that has occasioned the Commission to start to develop its own contacts internationally with our counterparts in other parts of the world.

In another area, we do have a proposal before the Commission for COMEX to link with a futures exchange in Sydney, Australia. And again, we are developing a working relationship with our counterparts in Australia.

Several of the other exchanges have developed what I would call more informal arrangements whereby look-alike contracts are traded on different exchanges, allowed certain margin or spread or straddle kinds of margin relief. So the relationship goes all the way from very formal, contractual relationships to less formal, and we are seeing—because of, certainly, the improved and enhanced technology that is occurring worldwide—even some FCM's keeping 24-hour trading desks open. We are seeing it at the exchange level, and I think that this is an area that you'll be hearing more on from us in the future.

Mr. JONES of Tennessee. Well, the second part of my question you've partially answered, but let me ask this also. Are you seeing any problems developing that would relate to your oversight and your jurisdiction as far as CFTC is concerned, in these areas?

Ms. PHILLIPS. No, sir; not with respect to the various linkages. We are, however, trying to develop relationships with several foreign governments with respect to the sharing of surveillance information, particularly for enforcement purposes, so that if there is a difficulty in one of our markets or if there is a difficulty in a foreign market that may affect one of our markets, we can have access to appropriate kinds of information. So those kinds of mutual understandings are in the process of being developed.

Of course, as you know, one of the amendments we have proposed would give us access to—or the capability to—subpoena participants in U.S. markets or those that are needed for an enforcement investigation.

So I guess to the extent that we have had difficulty in enforcing subpoenas, that is an area that we have sought some help from this subcommittee.

Mr. JONES of Tennessee. Thank you. I have one more, and I'm going to take the time; if we run out, you can stop.

Mr. Gunderson got into this just a little bit, but I'd like to continue it. Last year, a good deal of the Commission's time was spent in investigating the circumstances surrounding the default of the volume investors. Could you give us a brief review of your findings, as well as a description of the actions taken by the CFTC in relationship to this episode?

Ms. PHILLIPS. Yes, sir. In fact, it was almost 1 year ago to the day that we were notified that there was some difficulty with a member of the COMEX, volume investors, and that several of their customers were not going to meet a margin call. We received this information in the morning. The Commission immediately sent auditors into the firm to determine if they were going to be undercapitalized—undersegregated. We did determine that that was the case, and the Commission that evening took action to ask that a receiver be appointed to oversee the management of the firm. And by the time the market opened the next morning, the receiver was in place, and the receiver then could oversee the dissolution of the firm's assets and the redistribution of those assets to customers. So once it was in the court process, that was very helpful.

The Commission, however, felt that the occurrence of this situation in which the defaulting customers were trading gold options and were faced with a large move in the price of gold may have exacerbated the already tenuous capital position of the firm that was supporting large positions in the markets with insufficient capital.

We instructed our staff to do several things. First of all, we asked them to go and look at the capital rules and the customer position transfer procedures, essentially doing what I call a "horizontal rule review" of all exchanges. They did so immediately, and a number of exchanges made some specific changes to their particular systems in response to this situation.

In July of last year, the Division of Trading and Markets presented the Commission with a rather extensive report in which they recommended several things; one, that insurance be further studied by NFA, and NFA is in the process of doing that. They also recommended that we revise our capital rules so that the capital of the firms would more fully reflect the risk that is inherent in the positions, either carried by the firm directly or carried by customers. So we put out rule proposals in that area. We also put out some proposals with respect to transfer provisions, and also minimum margin guidelines with respect to writing call options.

So all of those things are now in process. And as I mentioned earlier, in the capital area, we have extended the comment period. As it turns out, that is a very complicated kind of proposal, and my feeling is that the industry also recognized that this is something that needed addressing and it needed a full measure of their attention. Several of the exchanges and FIA also have gotten involved in looking at various alternatives to the capital proposal.

In addition, there were enforcement actions that were brought with respect to specific individuals and firms.

So there was movement on a number of fronts. I believe that they are all of a regulatory nature, and I'm pleased to have this opportunity to bring you up to date. There is also a description on where we stand on the specific rules in the long statement that I have submitted to you.

Mr. JONES of Tennessee. Very good. Thank you, Susan. And the Chair does apologize for the additional time that he took with the questioning.

The Chair now recognizes Mr. Coleman.

Mr. COLEMAN. So FCM's now have minimal capital requirements, as determined by the exchanges or by you?

Ms. PHILLIPS. We do set minimum capital requirements, and——

Mr. COLEMAN. What are they based on now?

Ms. PHILLIPS. They're actually based on segregated funds. It's essentially 4 percent of segregated funds. And we really believe that that was a very good measure with respect to futures activity; but once you throw in options, and particularly writing options, segregated funds as a measure of business—so to speak—may not be as good a measure. So we may need to go to another basis, or have essentially a capital charge to reflect the increased risk.

Mr. COLEMAN. Well, was volume options?

Ms. PHILLIPS. Yes. They traded, certainly, other things, but the margin call that was missed was for writing options.

Mr. COLEMAN. Let me go back to the audit——

Ms. PHILLIPS. Excuse me. They traded, certainly, other things, but the margin call that was missed was for writing options, yes.

Mr. COLEMAN. All right. Let me go back to the audit trail for a minute, and I think I heard you say a while ago to somebody that the proposals, as you understand them, from the exchanges would meet the requirements of the rule. Is that what you said?

Ms. PHILLIPS. Certainly, once they get it implemented, if it does everything that the exchanges have represented, then we believe that it has the capability of meeting the requirements of the rule.

Mr. COLEMAN. All right. Now, what are those things you're looking for? Could you briefly tell me three or four items that you look at as far as whether or not this is going to pass muster?

Ms. PHILLIPS. Well, of course, we'll certainly be looking to see that trades are identified within 1 minute increments on the trade register.

Mr. COLEMAN. So the 1 minute is a firm standard that you have——

Ms. PHILLIPS. It is a standard. Of course, the question of compliance—whether or not 80 percent, 70 percent, 100 percent——

Mr. COLEMAN. What's your tolerance level there?

Ms. PHILLIPS. If we got 90 percent compliance we would be, I think, very pleased. I think, though, depending on—if you have very active pits, if you have a lower tolerance level under some circumstances, that of course may be acceptable. But if it's low consistently, I think we would want to look at and suggest ways for the exchange to shore up the system.

Mr. COLEMAN. Obviously, if the exchanges—I mean, theoretically—were to say that they couldn't do this, and you said that they must, you're not going to shut down all the exchanges, probably, in the country; so we're trying to work out some meeting of the minds here.

Now, in this process, July 1 is the time they have to give you a certain proposal, and then they have until October 1, I believe it is, to implement it according to how you feel it should finally be implemented beginning January 1, 1987? Is that right?

Ms. PHILLIPS. The rule goes into effect in October, and they would be utilizing it as part of their own compliance activities in January.

Mr. COLEMAN. Short of an actual operation, how do you see this thing developing—let's say that there was one that you thought was appropriate starting July 1, and it was fully operational October 1. How do they do this?

Ms. PHILLIPS. It would be up and running——

Mr. COLEMAN. From July 1 to October 1?

Ms. PHILLIPS. We are not requiring that it go into effect in July. What we are requiring is that it go into effect in October.

Mr. COLEMAN. But they have to prove it to you in advance, don't they, so that you know these tolerance levels and different accuracies and so forth?

Ms. PHILLIPS. What we would expect is that these exchanges would submit these plans to us, tell us how they expect to phase it in, test it, and so on. And we would see those in July or earlier to the extent that it is possible. In fact, I encouraged them to start submitting their plans even earlier with the appropriate rule changes.

Then it would go into effect. Now, I will say that if they are making good faith progress, they can certainly apply for an extension of the time period. But we would be looking to see what kind of good faith progress they are making with respect to the extension.

Mr. COLEMAN. Mr. Chairman, I have two small, short questions, if I might ask them, then I won't have to come back around.

Mr. JONES of Tennessee. Go ahead.

Mr. COLEMAN. Who does the general enforcement on boiler room operations? Is that a State—usually a State enforcement proceeding, or do you also do that?

Ms. PHILLIPS. With respect to off-exchange futures——

Mr. COLEMAN. Right.

Ms. PHILLIPS. For these kinds of transactions, we can bring actions and States also can bring actions, and sometimes we bring them jointly.

Mr. COLEMAN. Do most of them originate in the States?

Ms. PHILLIPS. Originate in the States?

Mr. COLEMAN. Or enforced in the States, as opposed to the CFTC.

Ms. PHILLIPS. No; I guess I would have to say that, at this point, either we are bringing them or there may be some joint action.

Mr. COLEMAN. OK. I guess the point that I'm going to get to is, let's say that we adopt your proposal on eliminating leverage from the act. I wonder if these people—who you've earlier said are not commercial customers—would start looking at these other operations as potential sites for their activities, and would encourage this type of activity? In a sense, you're trading off your enforcement on one and having to double it or put it over onto the boiler room operations that would increase or spring up. Is that something that you've thought about?

Ms. PHILLIPS. I guess I don't see that that would necessarily follow. To the extent that it is very clear that CFTC-regulated instruments must trade on exchanges, to the extent that they are not exchange-traded instruments, I think there would be a brighter line in terms of customers being able to identify what they could go into and should go into. I think we see it, in fact, as enhancing customer protection.

Mr. COLEMAN. Well, I guess the customers that involve themselves in this activity do it anyway today; I'm not sure how we're going to affect that. I mean, they're doing it anyway.

My last question, we have a moratorium in place now on leverage. If a company was interested in putting together an operation in the future, would they come to your Commission and let their thoughts be known, or would they have to wait until we lifted the moratorium—if that were the case—before they started putting together some sort of package, that they would want to duplicate what's out there now?

Ms. PHILLIPS. Right now, of course, they would have to come to us. But since the moratorium is in effect, it is with respect to previously identified firms.

Mr. COLEMAN. Right. But have people come to you, or companies come to you, saying, "Gee, we wish the Commission would lift the moratorium because we are interested in pursuing this activity"?

Ms. PHILLIPS. Yes; there have been some firms. And I think we've tried to describe to them what are the legal avenues available for them via some kind of installment, cash and carry kind of operation.

Mr. COLEMAN. OK. Thank you.

Mr. GLICKMAN [acting chairman]. Thank you, Mr. Coleman. I'll go ahead and ask mine now since I was next on the line.

First of all, Susan, I want to compliment you again for your leverage position. Even though it's not identical to what I've proposed, I think it substantively conforms. And while I may try to insist on my provision—probably will—I think that for the most part we've reached, generally, a meeting of the minds.

One area I may disagree with you on in your statement is a 6-year authorization. I think that is too long, and it would be my recommendation that we go no further than 4 years. That's a matter of policy that we have to make here.

The third thing is, there is testimony later on today by Tom Russo, and he presents some areas that you don't mention in your testimony that may be the subject of possible legislative changes. One has to do with the aggregation policy, which he proposes that when you aggregate positions, you do it on the basis of control, not ownership, like they do in the securities laws. One has to do with speculative position limits; one has to do with bona fide hedging definitions; and the other has to do with off-exchange trading, which is kind of an adjunct issue to the leverage issue.

What I would appreciate, because we don't have very much time today, is you look at his testimony and, if possible, you answer for the record the points that he has raised because I believe that in terms of new substantive legislative authority, his is the only testimony that I see to date that suggests possible additions to what you have talked about. And I would appreciate your supplying that.

[The material follows:]

COMMODITY FUTURES TRADING COMMISSION
WASHINGTON, D C 20581

OFFICE OF
THE CHAIRMAN

April 15, 1986

The Honorable Dan Glickman
U.S. House of Representatives
2435 Rayburn House Office Building
Washington, D.C. 20515

Dear Mr. Glickman:

During my March 18, 1986, appearance before the subcommittee on Conservation, Credit and Rural Development of the Committee on Agriculture you requested the Commission to submit its views on points being requested in the testimony of Thomas Russo. That testimony concerned speculative position limits, the Commission's definition of hedging, account aggregation and commodity trading advisor registration. The Commission has considered that material, and its views are reflected in the following discussion:

Speculative Limits and the Commission's Definition of Hedging

Speculative limits have a fifty-year history as part of the regulatory structure governing futures trading. A basic tenet of that history is a Congressional finding that prices on commodity exchanges are instrumental in interstate commerce and are affected with a national public interest. Speculative limits were authorized in the Commodity Exchange Act of 1936 for the purpose of diminishing, preventing or eliminating excessive speculation causing unreasonable or unwarranted fluctuations in price. This authority was first implemented by federal regulators for grains in 1938 and later extended to other major agricultural commodities. By 1975, when the Act was amended to include all commodities traded on contract markets, speculative limits were in effect for almost all actively traded commodities then under regulation, and the limits for about one-half of these had been established by the exchanges themselves. The Commission has reviewed the federal speculative limits for agricultural markets in the past, raising them for four different wheat markets in 1976 and eliminating daily trading limits for all markets subject to federal limits in 1979.

The underlying rationale for limits on speculative positions is that they provide an overall safeguard against excessive concentrations of speculative positions in the market. Such limits are not designed to control the aggregate amount of speculation in the market since they affect only the largest speculative traders. Consistent with this general prophylactic role, speculative limits are not intended to substitute for other regulatory safeguards such as adequate contract specifications, daily surveillance of large traders' positions, or financial requirements. Integral to the implementation of speculative limits are rules concerning which positions may be classified as bona-fide hedges and thereby be exempted from the limits and which accounts must be combined or aggregated for purposes of determining compliance with the limits.

As noted above, the Congressional finding that speculative limits may be necessary to safeguard the markets from major disruptions dates from 1936. Although this view was based primarily on experience in the grain markets, it was corroborated strongly in the cotton market in 1946 when a major market disruption resulted under speculative limits which had been set too high to provide the necessary safeguards. Notwithstanding this type of experience in major agricultural markets, many industry participants and academic experts expressed the view to the newly created Commission that speculative limits were unnecessary or would be ineffective in those commodities where there is a broad, liquid cash market and the ease of arbitrage closely integrates the cash and futures markets. An example of a market typically cited as falling into this category due to its broad international base and fungibility was silver. In late 1979 and early 1980, events in the silver market demonstrated that no contract market is immune from disruption at some level of speculative concentration.

In 1981, the Commission adopted Rule 1.61 requiring exchanges to establish speculative limits for all commodities which were then not subject to limits under either Commission or exchange rules. For the most part, this new rule involved the non-agricultural commodities such as financial instruments, metals and petroleum and forest products. Under this rule, which became effective in 1982, exchange limits are required to prevent the occurrence of positions which would be unusually large in relation to position sizes customarily held by speculative traders in that market or in relation to total open contracts. In addition, the exchanges may base limit levels on other factors such as the breadth and liquidity of the cash market and the opportunity for arbitrage between the cash and futures market.

These latter considerations have played a major role in the approval of many of the limits for financial futures, as evidenced by the fact that these limits are set liberally with respect to the normal size of larger speculative positions. 1/

1/ The total size of individual business operations in the cash market is not the determining factor in reviewing levels of speculative limits proposed by the exchanges. Among other (Footnote Continued)

That is, none of these limits appear to infringe significantly on the normal distribution of speculative position sizes in these respective markets. Further, in those cases where new markets have grown appreciably, such as U.S. Treasury Bond options, the Commission has demonstrated flexibility by approving increases in the limits when the exchange supplied data which would justify such a change.

The exchange submissions for initial approval of speculative limits and the supporting exchange rules required under Commission Rule 1.61 were extensive in nature, and most of the relevant exchange committees had no prior experience with speculative limit rules. As a result, many of the rules initially submitted by the exchanges were unsatisfactory due to the limit levels initially proposed or the exchanges' failure to provide for adequate enforcement procedures. A significant amount of Commission staff time was spent reviewing and providing guidance to the exchanges on necessary revisions to their speculative limit proposals. Commission approval of all such exchange rules was completed in early 1985.

Currently, the Commission's staff is reviewing the exchange limits, primarily those on livestock and soybean products, which were in effect prior to the promulgation of Rule 1.61 to assure that these exchange rules meet the new standards for both levels and adequate means of enforcement. In conjunction with requests from two exchanges, the staff is also reviewing the levels of federal limits for several principal agricultural contracts. The staff expects to complete both of these reviews to permit Commission action this year. It should be noted that any increases in such speculative limits must take into account the Commission's responsibilities for orderly markets. In that connection, while it is true that some federal limits have not been revised for some time, it is also relevant that the specifications of important contract terms such as delivery points have not been revised recently. Further, it should be noted that the size of several of these agricultural futures markets is significantly less than it was a few years ago. (See attached table.)

(Footnote Continued)
things, as noted above, the Commission believes that the liquidity in both the futures and cash markets is relevant to the proper specification of limits. Further, the total size of business operations does not necessarily indicate liquidity for individual transactions in either cash or futures markets. Finally, to the extent that commercial firms or institutions wish to use the market for hedging, they are entitled to exemptions from the limits as bona-fide hedgers.

If the Commission finds it appropriate to consider an increase in the position levels for the agricultural commodities which are subject to federal limits, any such proposal would be published for public comment. The Commission would consider the views of all interested persons, including its Agricultural Advisory Committee. As one might expect, the matter of speculative limits on agricultural futures is a very important issue to many agricultural producers and other agricultural businesses.

As noted above, the CFTC's definition of bona-fide hedging is an important component of its speculative limit policy since this definition determines an important class of exempted positions. The current definition was promulgated in 1978, and at that time the Commission intended that it should describe commercial risk reduction activities in all futures markets, including the relatively new financial futures. The Commission intends to re-examine this rule in the near future to assure that it continues to meet that objective and contemplates completion of its review during the first half of 1987. In particular, the Commission will consider, among other issues, the relationship of the Commission's hedging definition to the concept of prudent risk management and whether other uses of futures and option positions should be eligible for consideration under the non-enumerated portion of the hedging definition. It is noteworthy that the Commission's Financial Products Advisory Committee, at its April 10, 1986 meeting, recommended that such study and consideration begin.

Aggregation

The Committee has also heard testimony suggesting that the Commission alter its policies with respect to the aggregation of accounts for the purpose of speculative limits and that Section 4a of the Commodity Exchange Act be amended to facilitate this change. The proposed amendments would delete the provision requiring that all speculative futures positions "held" (or owned) by a trader be considered in determining compliance with speculative limits. 2/ This change would eliminate a primary basis for aggregating speculative accounts, leaving only control and concerted trading as the standards for determining compliance with speculative position limit rules.

The reason given for this proposed amendment is that the market activities of certain fund advisors may be inhibited by the current statutory requirement that all positions owned or

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2/ Full implementation also would require the Commission to amend Section 18.01 of its reporting regulations to extend to commodity trading advisors the same treatment concerning aggregation of futures positions that is currently applicable to futures commission merchants and commodity pool operators.

controlled by the same trader be aggregated for speculative limit purposes. Commodity pools, pension funds and investment companies were cited as active traders who may be inhibited by the current requirement.

The Commission does not support the proposed amendments since they would severely and unnecessarily undercut the purposes of the speculative limit rules. As previously discussed, speculative limits generally are set at levels that are sufficiently high that necessary speculative liquidity is not precluded. Furthermore, the current regulatory scheme already provides significant relief for commercial users of these markets. For example, pension funds and investment companies are eligible for hedge exemptions from speculative limits if they use futures or option markets to hedge their securities portfolios from adverse price fluctuations. Consequently, the activities of such institutions do not appear to be constrained unnecessarily by these rules and, as noted, the Commission intends to re-examine its rules to assure that they reflect hedging practices in the current market environment. It also should be noted that firms are also eligible for arbitrage exemptions for other types of trading in which they may engage.

It should be pointed out, however, that few if any commodity pool operators qualify for the exemptions discussed above. Accordingly, the primary effect of this proposed change would appear to be to permit commodity pools, engaging in speculative trading, to acquire larger positions than are allowed under the current speculative limit rules.

Commission staff is aware that representatives of several pools are opposed to the ownership standard for aggregating accounts for speculative limit purposes, particularly for those pools using several different commodity trading advisors to conduct the trading of a single pool of speculative capital. Currently, for speculative limit purposes the pool is considered a single participant in the market, and therefore the limits apply to all positions held by a single pool regardless of the number of advisors that the pool employs. In such cases the proposed amendment would allow each commodity trading advisor managing a portion of the assets of a single pool to hold futures positions at the speculative limit. As a result, the proposed deletion of the ownership criterion from the aggregation standard would likely reduce substantially or virtually eliminate the application of speculative limits to commodity pools as well as most forms of managed accounts. It should be noted, however, that a commodity pool operator may form any number of pools provided that the operator has less than a ten percent financial interest in each pool, the pools are different in design and purpose, and each pool is independently traded by different advisors. Under these circumstances the different pools are not aggregated for speculative limit purposes.

Commission staff has reviewed the trading of a single pool using different advisors in connection with a request for a no-action position on aggregation under the ownership criterion. In that case, although trading occurred at different frequencies, the staff concluded that a no-action position would be inappropriate because the advisors generally traded the same commodities and held net futures positions on the same side of the market. In short, it did not appear that the price impact of the positions of the different advisors would be generally random. This is not surprising since there are similar business interests and purposes in trading such accounts. Further, separate application of speculative limits to different trading advisors is of no consequence unless the advisors trade in the same direction, since speculative limits apply to net positions (total long minus total short contracts); that is, to the extent that different advisors to a commodity pool hold opposing positions in a futures or option contract, these positions would not exceed the speculative limit when aggregated.

Over the years the Commission has recognized a need to be cautious about the treatment of commodity pools under its speculative limit rules. The Commission's Advisory Committee on the Economic Role of Contract Markets, chaired by former Commissioner Seevers, noted a concern that large blocks of pooled capital being assembled to engage in trading on the basis of technical factors "...may provide less market stability than more standard types of speculative capital...", i.e., trading by independent individuals. 3/ More recently, public concern has been expressed about the potential cumulative market impact on agricultural futures markets of technically traded commodity futures programs that are highly capitalized, such as commodity pools and customer trading programs of an FCM. In particular, concern has focused on the highly volatile soybean prices of 1983. In the financial markets, program trading in stocks and stock-index futures and options has raised concerns about stock market volatility.

Such concerns are related to the Commission's responsibility to assure that the technical trading by such entities does not contribute to the "unreasonable or unwarranted price movements" that speculative limits are intended to diminish. To address this concern, the Commission is undertaking a review of selected position data in an agricultural and debt instrument futures contract to determine the extent to which commodity pools and trading programs tend to hold positions in the same markets and trade in the same direction.

3/ Report of the Commodity Futures Trading Commission Advisory Committee on the Economic Role of Contract Markets, July 17, 1976, p. 26.

Finally, the problems the Commission might encounter if this amendment were adopted are not restricted to commodity pools. Any speculator could establish multiple accounts citing fictitious controllers. It would be incumbent upon the Commission or the exchange to prove that common control exists. This is a lengthy and involved process since it generally requires that evidence be developed beyond showing a simple beneficial interest or similar trading pattern. Absent the relatively straightforward ownership standard, the capability of the Commission and the exchanges to enforce speculative limits for the whole spectrum of speculative traders would be seriously undermined.

Commodity Trading Advisor Registration

Mr. Russo also testified that the commodity trading advisor (CTA) definition should be amended to exclude persons registered with the Securities and Exchange Commission as investment advisers. This issue has arisen in the context of those investment advisers who wish to use the futures markets to hedge cash portfolios under management or for arbitrage purposes. The argument is made that this use of the futures markets is essentially incidental to the investment adviser's management of cash portfolios and, therefore, registration is not necessary. However, the Securities and Exchange Commission has no jurisdiction with respect to the futures-related activities of investment advisers nor are its regulatory programs focused on the integrity of the futures markets, a primary responsibility of this Commission. Moreover, unlike those entities that are excluded from the definition of a commodity pool operator under Commission Rule 4.5 because, among other things, they do not market their funds as a means of trading in the futures markets, these investment advisers are marketing their expertise in the futures markets and, thus, are holding themselves out as commodity trading advisors. Therefore, the Commission believes registration as a commodity trading advisor is appropriate.

Nonetheless, the Commission staff has considered and granted requests for a no-action position with respect to registration as a commodity trading advisor on a case-by-case basis, for example with respect to an investment adviser whose futures-related activity is both incidental to its primary investment activities and is confined to an affiliated investment company that is excluded from the definition of a commodity pool operator under Commission Rule 4.5. In addition, although no requests have been made in this regard, the staff believes it may be appropriate to accept compliance with certain of the recordkeeping and reporting requirements of investment advisers as a substitute for the Commission's requirements, such as certain of the requirements applicable to CTAs under Part 4 of the CFTC regulations. This would eliminate any duplicative regulatory requirements on investment advisers/commodity trading advisors.

Since the use of the futures markets by investment advisers is an area that is just beginning to develop, the Commission believes it is preferable to consider exemptions and exclusions on a case-by-case basis until sufficient experience is gained to permit the development of regulations in this area. The Commission has ample statutory authority under Section 2(a)(1)(A) of the Act to adopt regulations to exempt appropriate persons from the definition of a commodity trading advisor; additional legislation in this area is not needed.

The Commission appreciates your support of its program and your active participation in the reauthorization process. Please do not hesitate to contact me if you have any additional questions.

Sincerely,

Susan M. Phillips

Susan M. Phillips
Chairman

(Attachment follows:)

Volume of Trading [1] and Open Interest [2] For Corn, Wheat and Soybean on Chicago Board of Trade, and Cotton on the New York Cotton Exchange

Fiscal Years	Corn		Wheat		Soybeans		Cotton	
	Volume (Contracts of 5,000 bushels)	Open Interest	Volume (Contracts of 5,000 bushels)	Open Interest	Volume (Contracts of 5,000 bushels)	Open Interest	Volume (Contracts of 100 bales)	Open Interest
1970	1,270,576	40,150	540,827	19,272	1,271,613	38,088	33,000	2,290
1975	4,730,331	77,506	2,115,433	29,271	3,043,647	48,156	416,924	13,220
1980	10,310,168	185,437	5,258,534	56,535	9,364,201	125,351	2,472,650	42,934
1983	11,131,576	163,916	3,982,712	44,845	11,884,458	99,842	1,485,549	31,450
1984	10,206,725	182,117	3,191,284	52,771	13,542,101	91,223	1,268,292	27,498
1985	6,503,220	123,114	2,176,635	38,881	7,215,779	66,721	676,341	18,414

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[1] Total volume of trading for fiscal years. For the years 1970 and 1975, fiscal year is July 1 - June 30. Beginning in 1976, fiscal year was changed to October 1 - September 30.

[2] Open Interest is average monthend open interest for the fiscal year.

Mr. GLICKMAN In addition, I notice that next Tuesday you are considering a rule by the NFA—Customer Information and Risk Disclosure Rule. It's on your agenda, and Guideline for Disclosure of Costs Associated with Futures Transactions. The NFA, I think, has promulgated this proposal as a result of a lot of our prodding, and I think this concept is very important. I applaud the NFA for moving in this area, and I am going to presume that you are going to give this serious and expeditious consideration, this particular rule?

Ms. PHILLIPS. Yes. It is coming before us, and I think that we are glad to see it and I have not heard of any difficulties with respect to it.

Mr. GLICKMAN. OK. Good.

The next question has to do with the telescoping rule. As you know, you have a rule which deals with simultaneous expirations of index contracts, and that rule requires the gradual diminution of position limits to prevent last-day fluctuations. Is this rule working to stop the swings associated with what is referred to as "third Fridays"?

Ms. PHILLIPS. We actually only have that requirement with respect to two contracts, and they are both over-the-counter stock index contracts. There has not been a significant or large amount of volume in those two contracts, so I'm not sure it's had a very rigorous test, so to speak.

Mr. GLICKMAN. OK. Well, this rule is probably going to become more and more a matter of discussion as, I think, we begin to focus more on the relationships between futures and options and the securities industry. I urge you to keep us informed of how you think this rule is working.

The final point I would like to ask you goes back to this OMB involvement again. I shouldn't be concerned, but I am whenever I hear of the Office of Management and Budget getting involved in the regulatory process. I chair the Judiciary Subcommittee on Administrative Law, and one of the areas in our jurisdiction is regulatory reform. And as an independent agency, the OMB has a different relationship to you all than it would be if it was the Department of Agriculture issuing the rule. You're basically—well, you're independent. You relate as much to us as you do to the executive branch. And I want to make sure that not only are you reasonable—and I think you're working out this audit trail requirement with the exchanges to make sure that it is reasonable—but I want to make sure that you don't feel inhibited to move ahead in the regulatory area by the Office of Management and Budget, or by third parties, if you think it's in the public interest to do so.

Now, I wonder if you could describe again, a little bit, to me OMB's role in all of this. Did they just out of the clear blue come in and say, "We want to look at this rule"?

Ms. PHILLIPS. Well, actually, every time we promulgate a rule that has paperwork implications, we submit those materials to the Office of Management and Budget. And we do have an ongoing relationship with them. We have to submit a report to them every year describing, for example, what kind of paperwork burden hours are imposed and so on and so forth. So there is an ongoing relationship with OMB in that structure.

When we submit a new rule, we send it over to them. So that when they did notify us that they were interested in reviewing this rule—it seemed a little unusual, but it's not extremely unusual. They do——

Mr. GLICKMAN. How many rules have they reviewed under the Paperwork Act of yours, let's say, in the last year?

Ms. PHILLIPS. Well, they review all of our rules.

Mr. GLICKMAN. OK, but when you say it's a little unusual, what's a little unusual?

Ms. PHILLIPS. It's unusual for them to review a final rule. Ordinarily, we have our discussions with them when it's a proposed rule. In fact, we had those kinds of discussions with them with respect to 1.35g when it was put out in proposed form. So, it is unusual with respect to a final rule, but it is not unusual for them, I think, to get into these areas.

Mr. GLICKMAN. But they don't have any authority, as far as you're concerned, to prevent the issuance of a final rule, do they?

Ms. PHILLIPS. That is absolutely correct.

Mr. GLICKMAN. OK.

Ms. PHILLIPS. Absolutely correct.

Once they make their analysis, of course, we would have access to it. If the Commission determines—and has determined—that this is necessary for us to be able to carry out our responsibilities under the act, certainly it does not have the force of law.

Mr. GLICKMAN. One final point. On the off-exchange issue that I mentioned, that Tom Russo—it's one of the things that he talked about, are you looking at this issue, issues like swaps and a variety of different new generic kinds of things that are developing and what they are and how they should be regulated? And just specifically, how are you looking at it in terms of inside the Commission?

Ms. PHILLIPS. OK. I have not read Mr. Russo's testimony, but in response to your earlier request we will do so, and the Commission will respond to the points that he has raised.

Internally, the Commission has been aware that off-exchange activity, particularly in the forward-type market with respect to financial instruments, has been burgeoning in recent years—in the currency area, in the interest rate area. And because, in fact, of our concern, the Commission has set up an advisory committee to look into these various issues, the Financial Products Advisory Committee, and that is chaired by Commissioner Robert Davis. And so they are looking into a number of these issues.

It's really not clear whether or not these are the nonstandardized kinds of contracts that are very similar to the kinds of forward contracts that we have been familiar with in the agriculture market. It may be that it's a flip side of those kinds of contracts. And so, in that manner, we would approach their oversight in a manner similar to what we have done with other contracts.

We are looking at those areas, and I see it as an evolving, developing area, and we're not looking to go rushing in with regulations. What we are looking to do is see what is there first so that we can formulate whether or not they are appropriate areas in which the Commission should be delving.

Mr. GLICKMAN. Thank you very much.

Let's see—I think Mr. Evans?

Mr. EVANS of Iowa. Well, thank you, Mr. Chairman. I do have a couple of points that I would like to pursue a little bit further, I guess.

The 1985 farm bill contains a couple of items that relate to the futures industry. One of them is a point that says that the USDA will have some pilot projects on using the futures markets as a substitute for present price support programs—to explore the possibilities of using the futures markets to assure farm income.

Has the USDA approached that subject with you in any way at this point as to how they might handle that? Or has your staff given any thought to the possible implications of that?

Ms. PHILLIPS. USDA has not approached us, although I will say that we have contacted USDA to offer our assistance as they develop this pilot program.

I will say that I think that they have a number of very immediate concerns——

Mr. EVANS of Iowa. Yes.

Ms. PHILLIPS [continuing]. Before them, but we certainly stand ready to work with them as their pilot moves from planning stage to implementation stage.

Mr. EVANS of Iowa. Yes. I'm sure they are occupied with other things, and I'm not being critical of them either at this point, but I did want to make sure that the CFTC is aware of that. It's hard to say what might come out of that.

Following that same line a bit further, you know, one of the largest grain merchants in the world is the Commodity Credit Corporation of the USDA; and yet, at the present time, I think it is—in their judgment, at least—barred from using the futures markets at all. I'm not certain about that; I think that's their interpretation.

But there are some other things in that farm bill that say that when it is to the advantage of the Government, they should enter the market to do certain things in terms of cost saving. I note that, for example, they certainly are going to have obligations to acquire huge amounts of corn, for example, next September at $2.55 a bushel because that is the loan rate, and clearly there are going to be substantial amounts of forfeitures. I also note that the September corn contract is somewhere around $2.25; I don't recall exactly where it is.

It would seem that there would be very substantial advantages to the Government to—hedging, if you will, that requirement on the futures markets. This has never been attempted by the Commodity Credit Corporation. I'm not sure that it would be desireable, but has the Commodity Futures Trading Commission given any thought to the possible implications of the CCC entering into the market to use it for purposes of that kind, and how this might impact the operations of your agency or of the market, if you will, in commodities such as that?

Ms. PHILLIPS. First of all, let me say that nothing that we know of in our act would bar their participation.

Mr. EVANS of Iowa. Yes.

Ms. PHILLIPS. I must say, though, that I'm not completely familiar with their enabling legislation——

Mr. EVANS of Iowa. I think it is their enabling legislation that they've used as being inadequate for that purpose.

Ms. **Phillips**. I see. OK.

Well, then, in that case, I presume by their own strictures they are not allowed to come in. I think were they to come in, you would certainly see a much bigger open interest, and I suspect there would be some price effects.

Mr. **Evans** of Iowa. Would your judgment be that that would be a manageable situation from a regulatory point of view?

Ms. **Phillips**. I can't see any difficulty—they are certainly, obviously, involved in the cash market, and I don't see why it would cause us difficulties.

Mr. **Evans** of Iowa. I'm out of time. Thank you, Mr. Chairman.

Mr. **Jones** of Tennessee. Thank you very much, Cooper, for your participation.

Tom, are you next?

Mr. **Daschle**. Thank you, Mr. Chairman.

I'm still intrigued by the whole question of leverage. And I think as we look to reauthorization, it's going to be the one area that will probably generate the greatest amount of interest on the committee.

I'd like to go back to something that Tom Coleman brought up with regard to boilerrooms and how you see their role. Are they getting into leverage more now than they were? What do you see? How would you describe their role now?

Ms. **Phillips**. We have seen leverage used as a defense by some boilerroom operations that we were closing down. So yes, it is true we've seen it used as a defense.

I would say, though, that were leverage to disappear from our act, I'm not sure that that is going to, in and of itself, do away with the problem of boilerrooms. I guess I'd have to say I think it's really a function of what's going on in the markets and whether or not these various folks think they can gin up some interest in certain kinds of commodities. They would probably call them something else—cash forward contracts or whatever.

Mr. **Daschle**. What weight do you give the views of State law enforcement officials on the issue?

Ms. **Phillips**. We have been working very closely with them in this area and I'd have to say to you that I think we've developed a very constructive relationship with them. They really are the "cops on the beat," so to speak. They are out there; they often hear of complaints faster than we do, and they certainly see an obligation to protect the citizens of their States. So I think we see it as a joint effort.

Mr. **Daschle**. Let me, with what time I have left, talk a little bit more about the moratorium.

Under the moratorium how do you look at a new firm that would buy a grandfathered firm?

Ms. **Phillips**. Well, that issue really has not come before us. One of the original firms which was in bankruptcy had indicated an interest in becoming a leverage transaction merchant and had sought to transfer their leverage "rights," and we indicated at that time that they were not transferrable.

Now, that was a bankruptcy situation. If you're talking about a solvent firm, I think we'd have to look at whatever is the particular proposal that comes before us. And until I saw the particulars of it——

Mr. **Daschle**. Well, but just in—excuse me for interrupting; were you finished?

Ms. **Phillips**. Well, unless you can see exactly what the structure of either the sale of assets or merger or whatever, I'm not sure that we actually have the capability to stop certain kinds of sales of transactions. But it clearly has some public policy implications, and if it comes before us, I think we would want to publish it for public comment and look at the public policy implications of it.

Mr. **Daschle**. Generally, you're saying that you may accept some kind of arrangement, then, without being specific, whereby one company who buys a grandfathered company would then pick up the rights of that grandfathered company?

Ms. **Phillips**. It's possible. It depends on the nature of the arrangement.

Mr. **Daschle**. Could I ask you, just for the record, to elaborate on that answer with a little more specific information, if you could? I'd appreciate that. I think that would be one thing that would be very helpful to us.

[The material follows:]

WRITTEN RESPONSE TO AN INQUIRY FROM MR. DASCHLE

The Commission addressed the issue of a firm buying a leverage transaction merchant (LTM) under the terms of the statutory mortoria in a series of responses to letters from Congressman Dan Glickman during 1985.

In a letter dated August 16, 1985, Congressman Glickman expressed the view that "consistent with the statute and congressional intent, such a transfer would be incompatible with the moratoria." In an earlier letter to Chairman Susan M. Phillips, Mr. Glickman also stated that in addition "to preserving the letter of the moratorium, the Commission must also preserve the moratorium's spirit and intent, which would be undermined and violated by the transfer of the license of a registered leverage transaction merchant to an unlicensed company, specifically a firm not selling leverage contracts as of June 1, 1978."

Chairman Phillips responded to each of these letters by indicating that the transfer of a Commission license generally is not automatic but must be considered in the context of the particular facts and circumstances involved as applied to the applicable regulations.

In a response to Mr. Glickman dated July 30, 1985, Chairman Phillips specifically stated:

> As you know, the Commission took extraordinary care in developing the leverage regulatory program, including the moratorium. I can therefore assure you that the Commission would carefully consider all issues implicated by the moratorium if in the future any transfer of a leverage registration would in fact be proposed or arise and the Commission were called upon to exercise its authority to decide whether the transfer would violate either the letter, spirit or intent of its leverage regulations.

In a subsequent letter to Mr. Glickman dated September 4, 1985, Chairman Phillips stated:

> You may be assured that if and when we are called upon to decide the permissibility of a proposed license transfer, we would carefully consider all issues implicated by the proposal in order to preserve fully our intent in adopting the moratoria. Moreover, if the Commission determines that a proposed transfer impacts on the leverage moratoria, the Commission would seek public comment before taking action.

Mr. DASCHLE. As you view the moratoria in the longer term, do you think that ultimately lifting it is going to provide for more competition and help your industry?

Ms. PHILLIPS. I think it would certainly provide for some more competition within the leverage industry, yes. I certainly agree with that. I guess that the question that's really before us has to do with whether or not these kinds of contracts should be allowed to trade outside of the protections of the self-regulatory organizations. So I think that that is certainly one of the prime issues to address.

With respect to your concern about transfers, I think that there may be some kinds of transfers that may be feasible. Suppose the firm is wholly owned by one individual and that person dies? Can they then transfer that to their heirs? That would be one kind of transfer.

I'm not sure until you see the particulars of the kind of transfer as to whether there would be negative public policy considerations from such a transfer. And so I think once such an application came to us, we would take a look at it; but because of the kinds of concerns that this subcommittee has raised, I think we would want to seek broader comment on such a transfer.

Mr. DASCHLE. What I would like to do—and my time is up—is simply, maybe, to pose a couple of scenarios and ask what your policy might be under those scenarios. But again, I want to join with those who have already commended you for excellent testimony this morning and for your willingness to answer as many questions as you have. Thank you, Madam Chairwoman.

Thank you, Mr. Chairman.

Mr. JONES of Tennessee. Thank you very much, Tom.

Well, we will try to conclude this. I think Mr. English may have a question, but I have a statement I want to make to you before we do conclude because you'll not be here this afternoon, will you?

Ms. PHILLIPS. I can if you want me to, but I have some business back at the ranch.

Mr. JONES of Tennessee. It might be good if you were here. I'll leave that up to your judgment, though.

I want to take this opportunity to thank you for appearing. I think that you will agree that the members of this subcommittee are deeply concerned about the CFTC. Susan, we've had a good discussion today of the regulatory situation at the CFTC. As regards the audit trail, that's the thing that I really want to emphasize. It seems to me that this matter is one that needs to be worked out between the CFTC and the industry.

As one who has been sitting here for a good many years as chairman of this subcommittee, I've looked over several investigations that we've had of manipulations, and I'm the first to admit that better information is always needed. We never have all that we need. But I want to tell you and any other member of the Commission who's here today that this subcommittee is not going to hold hostage the reauthorization of the CFTC simply because of the audit trail controversy. The audit trail question should be settled, in my opinion, between the CFTC and the industry.

I think that this is something that we ought to take cognizance of and be sure that this is not to hold up the reauthorization process.

Ms. **Phillips**. I appreciate that, Mr. Chairman.

Mr. **Jones** of Tennessee. Now, I have one question; if you can answer it pretty hurriedly, because I want to give Glenn English a little time, too.

In 1974, again in 1978, and again in 1982, this committee and the Congress considered the question of leverage contracts. We concluded that they are not futures contracts, and that the CFTC must regulate the industry. After many years of needless delay, I want to compliment you for finally complying—and I want to emphasize "finally" complying—with the congressional intent in coming forth with leverage regulations. You are to be congratulated for that, as well as the rest of the Commission.

Now, my question is, if the Congress reaffirms its past position by not approving your legislative request, can and will the CFTC continue regulating the leverage industry? In other words, what I'm trying to say is, does the CFTC intend to abide by the law?

Ms. **Phillips**. Absolutely. Absolutely, Mr. Chairman.

Mr. **Jones** of Tennessee. Thank you very much.

That concludes my discussion, and I yield to Mr. English for whatever time we might allow him.

Mr. **English**. Thank you very much, Mr. Chairman. I appreciate it. I wanted to follow up a little bit on the audit trail issue.

I think there are some good points. And as I understand it, the CFTC and the industry have been carrying on a good deal of discussion about this issue. I think it is a good idea to have an audit trail, to develop an audit trail to safeguard the public, and I guess what I'd like to do is try to stake out, if we could, what progress has been made, what points of agreement that there are, and if they're to try to forestall and prevent any misunderstandings that might come out in the future. As I understand it, the industry is now just about ready to go ahead and to kick this thing off and get it moving.

Chairman Phillips, as I understand it, the Commission's purpose for adopting the regulation 1.35g was to create an effective audit trail. Is that correct?

Ms. **Phillips**. That is correct.

Mr. **English**. And in that regard, the 1 minute timing standard of the regulation was not to be interpreted or applied in its narrowest or most technical sense, is it?

Ms. **Phillips**. The 1 minute was meant to be and is a standard. It is a goal for which exchanges should, of course, strive. And how close exchanges get, again, is a question of compliance that the Commission must ultimately deal with.

Mr. **English**. So it was not intended to be interpreted at its most narrowest interpretation?

Ms. **Phillips**. In fact, it was what we viewed as a prudent compromise in order to try to get an effective audit trail. We certainly want sequencing of trades; that is the area that we specifically are concerned about.

Mr. **English**. Well, as I just referred, the industry—as I understand it—is developing a system that CFTC has looked at, the members have all had an opportunity to see a demonstration of it.

Is it the Commission's opinion that the Chicago Exchange's proposed audit trail system, known as the CTR, contains the necessary elements for compliance with your audit trail regulation?

Ms. PHILLIPS. If the system, as they have described it to us in the materials that they have submitted and in their presentations—if the system does what they say that it will, we believe it has the capability of meeting the standard.

Mr. ENGLISH. Does the Commission expect that this new CTR system when operational will comply with the new audit trail regulation?

Ms. PHILLIPS. When it's operational, if it meets the expectations of the exchanges, we believe that it would have that capability, yes.

Mr. ENGLISH. You testified that the Commission believes that the CTR system contains the necessary elements, I think assuming that the information that you've gotten is correct, to meet the requirements of the audit trail rule. I wonder, how are the exchanges protected under the rule if some subsequent Commission—or if you have some disgruntled litigant someplace who decides that the literal language should be applied? We were talking about this 1 minute rule issue. Would the exchanges be liable for not capturing the precise interpretation of that 1 minute rule, or would that reasonable level be applied? How could they be protected on that?

Ms. PHILLIPS. Well, of course, the standards for bringing suit against an exchange are, really, bad faith. And that would be the only way such a suit could be pursued.

I do not see how that could be—how bad faith could be imputed in such a situation.

Mr. ENGLISH. So in your opinion, rule 1.35g does not need to be amended to reflect both the reality, given the fast trading pits, or the limits of any possible trade timing system? Is that correct?

Ms. PHILLIPS. No, sir.

Mr. ENGLISH. I think, Chairman Phillips, that pretty much takes care of my questions. Again, I want to thank you for appearing.

Mr. Chairman, I appreciate the opportunity to be able to ask some questions.

Mr. COLEMAN. Would the gentleman yield for a moment?

Mr. ENGLISH. Certainly.

Mr. COLEMAN. Included in the proposal is not just the 1 minute, but the sequence of trades, and the card that the traders use and put down their trades in the pit, correct? That's part of their proposal?

Ms. PHILLIPS. CME and CBT have proposed that part of their particular approach would include a sequencing of individual trades by traders, yes.

Mr. COLEMAN. And your answer is based upon that being a part of their proposal?

Ms. PHILLIPS. That is part of their proposal, but it is not a part of our rule.

Mr. COLEMAN. It's not part of your rule?

Ms. PHILLIPS. No.

Mr. COLEMAN. In other words, you can do that a different way than what they've proposed?

Ms. PHILLIPS. Yes.

Mr. COLEMAN. But you want that information?

Ms. PHILLIPS. Yes; we want it. I mean, what we are saying is that we've set a general—what I would call an "umbrella" kind of rule, and exchanges can meet it in a number of ways. And these exchanges are opting for a computerized approach, and one of the ways they're going to gather the data to accomplish their audit trail is the sequencing of individual trades.

Mr. COLEMAN. Well, Mr. Chairman, if I might offer my commendation to the Chairman and her colleagues on the Commission. Susan Phillips has, I think, more than any other agency head that I've worked with, tried to keep Members of Congress informed. She updates us periodically throughout the years before reauthorization occurs, and I feel that we have a good open door policy. And I thank you for that.

Mr. JONES of Tennessee. Thank you very much, Tom. The Chairman wants to associate himself with the remarks of Tom Coleman. And thank you, Susan; we do hope that you can be here this afternoon for any question that might arise.

This subcommittee stands in recess until 2 p.m., when we'll hear panel No. 1.

[Whereupon, at 12:10 p.m., the subcommittee recessed, to reconvene at 2 p.m. the same day.]

AFTERNOON SESSION

Mr. JONES of Tennessee. The subcommittee will resume its sitting.

We are now ready for panel No. 1; as I call your names, will you come to the witness table?

Mr. Robert Wilmouth, president, National Futures Association of Chicago; Mr. John F. Sandner, chairman of the board, Chicago Mercantile Exchange, accompanied by Mr. Leo Melamed, chairman of the executive committee and special counsel, and Mr. William J. Brodsky, president and chief executive officer; Mr. Alan J. Brody, president, Commodity Exchange, Inc., of New York; and Mr. John Damgard, president, Futures Industry Association, Washington, accompanied by Mr. Jack Lehman of Shearson Lehman Bros.

Gentlemen, we are appreciative of the fact that you're here. We'll hear all witnesses, and then let the subcommittee ask you questions.

Chairman de la Garza, before we begin, do you have any statement that you'd like to make?

The CHAIRMAN. No statement, thank you.

Mr. JONES of Tennessee. Thank you, sir.

Mr. Robert K. Wilmouth, president, National Futures Association in Chicago, is first.

Bob, welcome; we're glad to have you, and you may proceed.

STATEMENT OF ROBERT K. WILMOUTH, PRESIDENT, NATIONAL FUTURES ASSOCIATION

Mr. WILMOUTH. Thank you, Mr. Chairman.

As you know, I am president of National Futures Association, the self-regulatory organization of the Nation's futures industry.

Four years ago, when I appeared before this committee, I had no way of knowing I would shortly be called upon to help build NFA;

yet, I joined with many others in this industry in affirming that it could be accomplished and that, given the chance it would be accomplished.

You gave us that chance. And you wisely asked that, after 3 years, we account for ourselves with a report on our performance. A full text of that report, which is entitled "The First Three Years," has been furnished to the committee and staff.

[The report is held in the committee files.]

Mr. WILMOUTH. Before addressing the specific legislative recommendations which the CFTC has submitted, allow me to briefly bring you up to date on a few of the highlights of NFA's 3 three years, highlights which clearly confirm that NFA is a promise fulfilled.

NFA has fulfilled its promise to relieve the CFTC of the burdens and costs of direct regulation. As a result, CFTC has been able to utilize its available resources more effectively in connection with its oversight responsibilities.

NFA has fulfilled its promise to fill what were then regulatory gaps, specifically, nonexchange futures professionals. By extending a guiding hand, we feel we have had a tremendous impact on voluntary compliance.

At the same time, NFA has also fulfilled its promise to apply a firm hand when and where needed. Where the public trust has been abused, we have the power to be firm, the resolve to be firm, and an impressive record of being firm. We strive to be fair; we do not strive to be gentle.

NFA has fulfilled its promise to extend the battle against unethical sales practices beyond the bounds of the legitimate futures industry, to slam the door on regulatory safe havens for the unscrupulous. A case in point has been our efforts to assist the North American Securities Administrators Association in drafting and enacting a Model Commodity Code, putting flesh on the bones of the open season provisions which you enacted in 1982. Another example has been our aggressive, highly successful educational effort, a coordinated, nationwide campaign against commodity fraud.

We have also fulfilled our promise to promote observance of high standards of ethical conduct. Just as the enforcement of our rules has been tough, so have the rules themselves—rules made by the industry having to do with the handling of discretionary accounts, with advertising, with fee disclosure, and with "know your customer" requirements, to mention but a few.

NFA has fulfilled its promise to strive for ever-higher standards of knowledge and proficiency in the futures industry. Among other things, we have established uniform, industry-wide testing for all new associated persons and imposed a 2-year experience requirement for brokerage AP's who manage discretionary accounts.

NFA has fulfilled its promise to take over the CFTC's arduous registration tasks, doing virtually everything the CFTC was doing plus registering IB's, the fastest growing industry sector, plus issuing temporary licenses to all eligible associated persons.

We have fulfilled our promise to avoid becoming a duplicative regulatory layer. We have worked closely and continuously with exchanges, not only to prevent overlap, but to harmonize existing compliance requirements.

NFA has fulfilled its promise to provide a system for fast and fair resolution of customer claims against futures professionals. Our highly successful arbitration program has over 1,100 volunteer arbitrators in 48 States.

NFA has fulfilled its promise to be efficient and to promote efficiency. Example, reducing the number of separate registration forms. Example, more audits and thorough audits in relation to the size of our audit staff. Example, creation of a state-of-the-art data processing capability to speed registration, and automate complex financial audit and surveillance functions.

We have fulfilled our promise to avail ourselves of the best and brightest talents from both within and without the futures industry. It's simple—good people do good work; and if you'll indulge my pride, we do have good people, experienced people, well-trained people, and they do indeed do good work. In addition to these staff capabilities, we are fortunate in being able to tap the valuable talents, expertise, and energies—without cost—of the members of our committees, governing bodies, arbitration panels. And these include former CFTC Commissioners, current and former exchange chairmen and presidents, brokerage firm CEO's, former CFTC staff, and the list goes on.

Finally, and perhaps most importantly, I think, NFA has achieved its promise and its very ambitious goals without spending a single penny of taxpayer money. It is an entirely self-financed body. NFA has clearly demonstrated the continued willingness of the futures industry to bear its fair share of the cost of regulation.

We have also saved taxpayers, over the course of 3 years, in excess of $35 million that it would otherwise have cost the CFTC to perform those functions now being performed by NFA.

There are several legislative proposals of the CFTC which could impact our continued ability to do our job well. We support two of these proposals, one in which an NFA member who is subject to NFA disciplinary action could automatically stay that action by simply filing a piece of paper with the CFTC without showing any cause whatsoever. This provision unintentionally undercuts our ability to protect customers in emergency situations. The CFTC proposes that the granting of a stay should be discretionary, and we agree.

There is really only one proposal that is significant with which we strongly disagree. This is the one which would give the Commission virtually complete authority to alter or supplement—in essence, to write—our rules. This proposal is unnecessary and unwise. Why? At no time did Congress or the CFTC see the need for this power when we were originally created, and we have acted in every matter that has been brought to our attention—"know your customer" rules, acceptable content for advertising and solicitations, proficiency testing, discretionary trading only when an experience requirement is put in place, stringent supervisory requirements—we've acted on all of these very tough issues, and we have succeeded because we have a process that works. It's a process that owes its efficiency to NFA members, to staff and governing bodies that carefully consider, closely scrutinize, and painstakingly dissect and redraft and refine every appropriate rule that we are taking into consideration.

The CFTC must approve our rules which are consistent with the requirements of the act; and within that standard, we are permitted to exercise our informed judgment.

The key question, I suggest, is what would happen if, as proposed, the Commission could substitute its judgment for NFA's simply by threatening to exercise an amendatory veto? The answer is clear. There would be no incentive to even discuss, much less tackle, solutions to tough ethical questions, not if there is a real possibility that the solution will be freely rewritten.

The current proposal rewards the exemplary performance of NFA's members by undercutting their authority, by substituting Government regulation for self-regulation, by transforming a cooperative process into an adversarial process, by threatening to make NFA no more than the CFTC's "Division of Self-Regulation." It just doesn't make any sense. Nor do their reasons stand up. The argument that they should have this authority over NFA because they have similar authority over exchanges places symmetry above substance. We are not the contract market; our interests are different. Our level of congressional guidance is different.

The Commission also argues that certain anomalies result from its lack of authority to rewrite our rules. They're not anomalies; they're mirages, perceived problems that don't exist. For example, it contends that it is powerless to require NFA to alter its financial requirements; not so. Congress took care of that in the statute. It can require us to alter ours merely by altering its own. Similarly, wherever the CFTC feels NFA ethical standards or guidelines are inadequate, it already has authority to remedy any perceived shortcomings through its own rulemaking process. This is a far more appropriate way of dealing with such issues than the authority now being sought.

In sum, this proposal does not merely try to fix something which is not broken. It threatens to break something that is working extraordinarily well.

Allow me to conclude my remarks by noting that, on each of the previous three occasions that you have taken a close look at the structure of futures trading, you have made one consistent point: you wanted NFA. In 1974, NFA was no more than an idea. In 1978, it was brought into sharper focus. And in 1982, it became not only a goal of the Congress, but a promise by the futures industry. We asked for the chance to regulate ourselves; you gave us that chance.

We believe your expectations have been met, and perhaps exceeded, and that the promise has been fulfilled. We believe, too, that self-regulation holds still greater promise, and we look forward to its fulfillment in the manner in which we have accomplished our objectives to date.

Thank you.

[The prepared statement of Mr. Wilmouth appears at the conclusion of the hearing.]

Mr. Jones of Tennessee. Thank you very much, Bob, for a good statement. We do appreciate it, and I assure you that every item that you suggested will be given a good, serious look before we move ahead with reauthorization.

If you will remain there, or at least be there at the time of the completion of the panel, we'd like to have the opportunity to question you.

Our next witness is Mr. Jack Sandner, chairman of the board, Chicago Mercantile Exchange, accompanied by Mr. Leo Melamed and William Brodsky. Welcome, gentlemen, and you may proceed.

STATEMENT OF JOHN F. SANDNER, CHAIRMAN OF THE BOARD, CHICAGO MERCANTILE EXCHANGE, ACCOMPANIED BY LEO MELAMED, CHAIRMAN, EXECUTIVE COMMITTEE AND SPECIAL COUNSEL, AND WILLIAM J. BRODSKY, PRESIDENT AND CHIEF EXECUTIVE OFFICER

Mr. SANDNER. Thank you, Mr. Chairman.

Before I begin, Mr. Chairman, I'd like—with your permission—to submit for the record my written comments and statement on the issues. I would, with your permission, like to just summarize those rather than read from the testimony as the testimony would exceed the time, I'm sure.

Mr. JONES of Tennessee. Without objection, that is agreeable.

Mr. SANDNER. Thank you, Mr. Chairman.

As you might know, Mr. Chairman, I served as chairman of the exchange in 1980, 1981, and 1982; and over my years at the exchange, I served as chairman of the Business Conduct Committee, commodity representative, Customer Complaint Committee, and a newly formed committee called the Probable Cause Committee which, if you will, is the "grand jury" of the exchange wherein we look for improprieties and try to detect trade infractions and what have you and determine whether there is probable cause to make charges.

Those three adjudicatory committees have given me a wealth of experience in dealing with the type of things that we're going to look for in the audit trail reconstruction.

But let me digress for a moment and stress—because I think it's very critical—the nature of our industry and how it's grown over the last 15 years. We've grown from doing volume with our institution of 3 million contracts to over 56 million contracts. We've gone from a domestic stage to an international stage, and presently we receive overnight from foreign shores over $1 billion in deposits in the United States. In fact, today we just concluded our March foreign currency contracts and we took delivery and handled deliveries of over $3.5 billion of foreign currencies at our exchange, the Chicago Mercantile Exchange and its division, the International Monetary Market.

Today, there is no question that we play a critical role in the risk management in the worldwide structure and the economic structure worldwide, both in the agriculture and the financial sectors. Indeed, I believe we are the envy and the model for financial institutions around the world. My years of participation in the futures industry, I believe, give me enough experience to say that I think I know the needs of public customers; I think I know the needs of hedgers and speculators, and I think I know the need for liquidity in the marketplace. And just as important, I think I know the need for prevention and detection of trading abuses

Which leads me to a very critical and central issue, and that is audit trail. I'd like to first clear up a misunderstanding, I think, that maybe none of you are under but that some are under, that the Commodity Futures Trading Commission wants improved audit trail in the exchanges; the industry does not want an improved audit trail. There's nothing further from the truth. I believe all of us have the mutual goal of an improved audit trail. The issue, really, surfaces because it is over the debate of a rule which we interpreted, under 1.35g, to require manual recordation to the minute of trades.

On its face, the rule appeared to be very, very destructive and inflexible; at least, that's the way we interpreted it. The rule caused a tremendous human cry, Mr. Chairman, in all segments of our industry—the exchanges, the clearing firms, and many of our customers. The rule, if implemented as we interpreted it, would have brought the speed of execution and the speed of reporting of execution, which is so vital to the flow and ingress and egress of the marketplace for our customers, to a snail's pace. It would have virtually destroyed our liquidity and would have crippled our vital industry. At the same time, it would have been tremendously costly to the public.

The angry protestations of the industry led to an extremely constructive dialogue over the last month to 6 weeks. And as a result, we were able to ascertain the correct interpretation of the Commission's mandate and audit trail demand.

The CFTC indicated that we misunderstood their demands, and said that, first, audit trail standards would be flexible; second, that 1.35 would not be interpreted in its narrow, most technical sense; and third, that the purpose of audit trail in 1.35 is to create an effective audit trail, and that 1-minute time stamping and standards are not going to be controlling.

The issue, therefore, came into sharper focus; that is, the CFTC was demanding and is demanding from us a system of effective audit trail, a goal with which we are in entire agreement. Pursuant to that end, the CME and the Chicago Board of Trade have worked very, very, very hard for the past several months, developing and creating a system to give us an effective audit trail. That system we call Computerized Trade Reconstruction, CTR. I have with me and will give to the committee a copy for the record of this system.

[The report is held in the committee files.]

Mr. SANDNER. The CFTC asked for a presentation of this system several weeks ago, after which they said they were very pleased with the system and felt that the system would comply with the standards that they felt were necessary for adequate audit trail. And therefore, Mr. Chairman, based on that constructive dialog over the past several weeks—much of which, I might add, has been embodied in correspondence between the CFTC, the exchanges, and the Senate subcommittee chairman who held hearings a couple of weeks ago on these issues—we feel now that because of this constructive dialog and the attempts of both the CFTC and the exchanges, we are well on our way of getting this issue behind us.

I would like to take a moment to address another issue and get off the audit trail issue for a minute, forgive the pun. The issue is rulemaking, the rulemaking process of the CFTC. A case in point is the capital rule that they promulgated several months ago. That capital rule came out of nowhere, as far as we're concerned. The catalyst was the failure of Volume Investors.

After an investigation by the CFTC and others, it was determined that the failure of Volume Investors was not the result of an inadequate capital rule in our industry, but rather the result of a violation of already established rules. Nevertheless, in kneejerk reaction, the CFTC promulgated a capital rule which would have closed a substantial number of our firms, firms that have had a flawless and impeccable record over many years of dealing with the public, merely because one firm failed—not as the result of inadequate capital rules in the industry, but as the result of violation of already existing regulations.

We agree that from time to time we should review our capital rules and perhaps strengthen them. But we would only do that with a good deal of deliberation and analysis and careful thought processes.

We would like to the CFTC to invoke the same safeguards in the rulemaking process; and accordingly, we will make a legislative proposal for the CFTC rulemaking process to you.

Regarding the capital rule, I think it's worthy to note that the Chicago Mercantile Exchange in all its years, in all its history—no customer at our exchange has ever lost one penny as a result of a default of a clearing firm.

Another issue, if I may, I'd like to discuss the Options Pilot Program and new contract approval, sort of merge both issues.

As you know, the Options Pilot Program—perhaps well-conceived at its beginning—ended October 1985. Well, the CFTC still is adhering to the basic limitations and restraints of that program. We believe we have an excellent record in options, and that program ought to be lifted. We believe that the financial institutions and the agricultural institutions need the risk management tools of options.

The farm bill which was recently passed through Congress—much of its intent is to deliver the Government up, in a way, from funding the farmers in the agricultural community, and deliver to the free market in funding from the private sector. Well, if that is to take place, there is no way that the private sector will fund farming if farmers do not have appropriate risk management tools. The agricultural community needs options in order to have transfer of risk mechanisms which are very appropriate for the next 10 or 15 years to bring the agricultural dilemma into proper perspective and out of the doldrums. There is no way the private sector will fund the agricultural community without these risk management tools.

We believe the CFTC is coming around on those issues, and hopefully will open up the pilot program and approve options as we request them.

A tangential issue is the following, that even though we have contracts able to be approved in the restraints given to us by the Options Pilot Program, the CFTC has been very derelict—in our opinion—in approving these contracts in an expeditious manner. We would like to play on a level playing field with the securities industry on this issue. The securities industry, first, has no limitations as a pilot program on options. When they would like an option, especially on products that we are creating and developing, they draw up a contract with specifications and they submit it to the securities exchange and it is approved in record-breaking time, certainly relative to when the CFTC approves our proposals. An example in point is the Japanese yen option which ties in the pure new contract approval, which we are very out of sorts with the CFTC on that issue. It takes the securities exchange approximately 140 days to complete review and approve application for a new contract, a contract that is on all fours with a contract that we would apply for. It takes the CFTC over 1 year to do it, over double the time.

There are many other issues, and they are addressed in the testimony which I have submitted to the committee. But let me conclude that we represent a very large and important institution in a uniquely American industry. But as sure as I'm sitting here, we will lose our competitive stance with foreign competitors who are this minute creating and developing contracts, creating and developing exchanges which are identical to what we created over the past 100 years.

If the CFTC continues in passing and promulgating rules which are restrictive and destructive, and that rulemaking process goes on unchecked, we will certainly lose our competitive edge to other countries. The seeds of destruction of this industry in America will be planted unless Congress directs the CFTC to adhere to the demands of the free market and to be ever mindful of the cost to our industry of regulation, while taking into consideration and weighing the benefits of that regulation.

With the help of the reauthorization process, we hope that we will be able to resolve these issues and these difficulties with our regulators.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Sandner appears at the conclusion of the hearing.]

Mr. JONES of Tennessee. Thank you very much, Mr. Sandner, for your statement.

Mr. Melamed, do you have a statement?

Mr. MELAMED. No; I just second Mr. Sandner's statement.

Mr. JONES of Tennessee. Mr. Brodsky, do you have a statement?

Mr. BRODSKY. No, sir. Thank you.

Mr. JONES of Tennessee. We appreciate you gentlemen being here with Mr. Sandner.

And then our next witness is Mr. Alan Brody, president, Commodity Exchange, Inc., New York.

Mr. Brody.

STATEMENT OF ALAN J. BRODY, PRESIDENT, COMMODITY EXCHANGE, INC.

Mr. BRODY. Mr. Chairman, thank you very much.

Mr. Chairman and members of the subcommittee, as you indicated, my name is Alan J. Brody, and I'm the president of the Commodity Exchange in New York, also known as the "COMEX," the world's foremost futures and options market in precious and industrial metals. COMEX accounted in 1985 for better than 95 percent of the U.S. trading volume in gold, silver, copper, and aluminum futures. Throughout the world, our prices on COMEX are quoted and watched.

Mr. Chairman, like some of the others at the panel here, with your permission I will submit for the record an extended statement covering a number of issues that reauthorization should address.

Mr. JONES of Tennessee. Without objection, we'll be happy to comply.

Mr. BRODY. Thank you very much.

In my abbreviated remarks, however, I would like to present a final report on the successful resolution of a challenge created a year ago when a COMEX member firm by the name of Volume Investors Corp. sustained insolvency. Mr. Chairman, you yourself raised that issue this morning during the chairman of the CFTC's testimony; Mr. Sandner alluded to the matter, as well.

I will also outline why COMEX, supported by many of the other major exchanges in the United States, urges that the rogue form of futures trading—known as "leverage contracts"—should be denied its present privileged status as the only futures activity that can be offered under noncompetitive and largely unpoliced conditions.

Finally, I will express COMEX's support for a joint solution between the industry and the CFTC on the contentious and critically important issue of transaction audit trail.

First, regarding Volume Investors Corporation. Although the subcommittee may already be familiar with the events leading to Volume Investors Corp.'s insolvency, please permit me a moment to recapitulate.

As you may recall, the gold market was quiet—even somnolent—in 1984 and for about 75 days into 1985. Then, suddenly, a combination of economic crises, such as a run on troubled thrift institutions, caused gold prices to surge dramatically. In only 2 days, gold futures prices rose on COMEX an unprecedented $44 an ounce, and the gold option premiums on COMEX increased as much as 700 percent.

Volume Investors Corp., which I will shorten to "Volume" for purposes of this discussion, carried large positions in gold futures and gold options on COMEX for both public and floor trading customers. On the eve of the gold surge, Volume Investors Corporation s apeared to have ample capital; indeed, its resources were more than twice the amount required of by the CFTC. Even so, the spectacular rise in gold prices in the short period of 2 days would prove too much for Volume, due to yet another rare event. Three of its largest customers in gold options reneged on margin calls of about $15 million causing Volume, in turn, to default on its own obligations to COMEX Clearing Association, the corporation that clears all the transactions on the COMEX.

Through this period and in the days that followed, COMEX kept the CFTC fully apprised of the developments and, in fact, CFTC personnel were on the scene and we reported regularly to the CFTC's leadership in Washington.

An examination of Volume's books after a court-appointed receiver had liquidated all customer positions indicated that, when all of Volume's remaining resources were combined, there were about $3.5 million less than was needed to repay all nondefaulting customers.

Well, I am pleased to report to this subcommittee that the Federal district court in New York recently approved a COMEX-led plan to assure that every customer of Volume receives the full equity in his or her trading account; in fact, Volume's customers have now been mailed the checks for the balances in their trading accounts, and the episode—despite its complexity and occasional frustrations—has ended with zero losses in the accounts of nondefaulting customers.

And so I can conclude the Volume episode, repeating what Jack Sandner said about the Chicago Merc, that no customer has ever lost money on the COMEX as a result of the default of a clearing firm.

On to the leverage contract issue, to which there was much testimony earlier this morning.

COMEX, as many of you know, has been an outspoken critic of the special dispensations awarded a handful of companies that sell so-called leverage contracts to small public investors. That activity has been allowed to operate with almost none of the safeguards imposed on futures markets and, not surprisingly, has spawned an unparalleled number of complaints to the CFTC by disenchanted leverage customers.

The time has come for Congress to put a halt to that activity, and the way to do so is by simply declaring that leverage contracts are futures contracts that must be traded, if at all, on an exchange where customers can enjoy competitively set prices, the safety of a clearinghouse guarantee, and the protection of formal self-regulation.

Among the reasons why leverage should be stripped of its privileged status are these.

First, leverage contracts are actually futures contracts. COMEX, the Chicago Board of Trade, and the Chicago Mercantile Exchange have conducted a comprehensive study of leverage contracts and have reached the same conclusion as the CFTC's own staff several years ago, and reconfirmed by the CFTC in this reauthorization—namely, a contract for the future delivery of a commodity at a pre determined price, incapable of offset, is, regardless of name, a futures contract under the Commodity Exchange Act.

Second, off-exchange futures trading is unlawful and has been so since the earliest Federal legislation in 1922.

Third, futures trading must have a hedging or price discovery purpose and cannot be purely speculative. Leverage has only one purpose, that being speculation.

Fourth, leverage contracts and fraudulent conduct have been inseparable partners. The absence of any self-regulatory machinery and the limited resources that the CFTC can devote to Federal oversight of that industry virtually guarantee sharp practices, unfair practices, and one-sided contract terms.

Fifth, leverage contract dealers enjoy monopoly power to set prices, to dictate contract terms, and to leave customers guessing whether their contracts will be bought back by the merchant if they become profitable. Our laws simply do not allow such an imbalance of power as between the dealer and his customers, except in this aberrant field.

Sixth and finally, the legitimate futures industry does not want the taint of this shadow enterprise, nor should the CFTC bear the brunt of criticism for the scandals that are a permanent fixture of the leverage business.

Well, the leverage merchants claim that their treatment as futures vendors would be the death knell of their business. This is utter nonsense. The largest leverage merchant has already taken precautions against that eventuality by becoming a CFTC-registered futures commission merchant, such that even after leverage's departure, can continue to maintain a lucrative brokerage business in legitimate instruments. Other leverage merchants can do likewise, joining the hundreds of firms that make money as FCM's without skirting the rules.

Accordingly, Mr. Chairman, COMEX urgently requests that Congress require these few leverage merchants to abide by the law. While the CFTC has proposed one solution, which is a welcome step in the right direction, we think that the approach taken in H.R. 3434—which would directly, simply, and finally declare leverage contracts to be unlawful futures—would be the better method of dealing with the problem.

I mentioned in my introduction that I'd like to spend a moment on the audit trail issue, so just 1 more minute, if you please.

Much has been written in the press about a conflict between the industry and the Commission over new regulation, section 1.35, as it imposes additional audit trail details that must be entered into trading records at the same time that orders are being executed on the trading floors of the exchanges.

The industry has expressed valid fear that market liquidity, not to mention the quality of executions, will suffer from this requirement.

COMEX agrees that the effects on trading have not been given appropriate consideration by the Commission. Instead, the agency has seemed to do little more than determine that more information is better than less, irrespective of the cost to the trading public. At a minimum, the Commission should be put to the task of supporting this intrusive new duty with a meaningful cost-benefit analysis.

COMEX has been and will continue to be cooperative with the Commission in seeking an audit trail system that truly provides benefits to the trading population rather than impeding every single execution for the sake of detecting an infrequent or remote violation. Cooperation is essential because many of the exchanges trade in somewhat different ways—most New York markets, for example, do not trade in the same style as Chicago—requiring audit trail systems that a single, uniform approach cannot satisfy.

So COMEX fully supports an accommodation between the industry and Commission on this matter, and notes that a serious dialogue consistent with that spirit has been underway for some time between the Commission and the two largest Chicago futures markets.

We, too, would welcome a similar dialog with the Commission. We remain confident that, in due course, the Commission—with the industry's help—will arrive at an audit trail program that provides new data without strain on the delicate market machinery that traders rely upon for efficient pricing and low transaction costs.

Mr. Chairman, that concludes my oral remarks and I, of course, would be pleased to answer any questions that you or other members of the subcommittee may have. Thank you.

[The prepared statement of Mr. Brody appears at the conclusion of the hearing.]

Mr. JONES of Tennessee. Thank you very much, Mr. Brody. We do appreciate your statement.

I think at this point the subcommittee will stand in recess for a vote, and then ask that you be here as we return. And Mr. John Damgard will be the next witness.

[Recess taken.]

Mr. JONES of Tennessee. When the subcommittee recessed for the vote, we had one remaining witness on the panel, Mr. John Damgard, president, Futures Industry Association in Washington, accompanied by Mr. Lehman.

John, you may proceed, and I don't know if Mr. Lehman has a statement or not. If he does, he can follow you.

STATEMENT OF JOHN M. DAMGARD, PRESIDENT, FUTURES INDUSTRY ASSOCIATION, ACCOMPANIED BY JACK LEHMAN, CHAIRMAN

Mr. DAMGARD. Thank you, Mr. Chairman. No; Mr. Lehman is here as the chairman of the Futures Industry Association, and more to respond to any questions that the members might have following my remarks which I will, as other witnesses have done, try to summarize and stay within the time constraints.

Mr. JONES of Tennessee. Without objection, your entire statement will be made a part of the record.

Mr. DAMGARD. I appreciate that very much.

I am John Damgard, president of the Futures Industry Association. Accompanying me today is Jack Lehman, our chairman. The FIA is the national trade association for the commodity futures and options industry. Our regular membership is composed of over 100 brokerage houses, called futures commission merchants or FCM's. FIA member FCM's are estimated to transact over 80 percent of the public customer trade on U.S. commodity exchanges. Our association also counts among its membership all U.S. exchanges, many law and accounting firms, foreign exchanges, foreign brokerage houses, and both domestic and foreign banks. While we value all of our members and strive to represent the industry as a whole, our roots are in the brokerage community and we remain primarily an FCM organization.

FCM's are the industry's link to the trading public. Our members serve public customers, be they farmers, mutual funds, pension plans, savings and loans, or local or foreign governments. FCM's must assure the public that these markets are fair and answer to the public on those occasions where the perception is to the contrary. Thus, we have a vital interest in thoughtful regulation of the marketplace and increased efficiencies in the transaction of business. Our public demands this, and we can accept nothing less.

The FIA recommends reauthorization of the Commodity Futures Trading Commission for a 6-year period, but we'll take 4. While the FIA is generally pleased with the evolution of regulation under the CFTC, there are a number of programs and issues—some of which are regulatory and not legislative in nature—about which I would like to briefly comment.

In the interests of time, let me just say that on options, we support the expansion of the options program and we would like to see the CFTC move to eliminate all restrictions.

On insurance, the controversial volume investors problem gave rise to renewed cries by some that the commodity futures and options industry should provide insurance or customer account protection in some form. The importance of customer confidence in the financial integrity of the futures markets is tremendous and, I would add, well-deserved. Between 1971 and 1984, customer losses amounted to $9.7 million in the commodities industry. During the same 13-year period, total securities customer claims amount to almost $690 million, for which SIPC paid out $153 million; $10 million in securities customer losses were not covered by SIPC. Thus, even with the SIPC Program, customer losses in the securities area exceeded those in commodities. Insurance in the securities industry and other segments of the financial marketplace, including banking, has presumably played a significant role in the protection of customer funds, but at what cost? Do market users exercise less than sound business judgment in selecting a firm when there is an insurance program in place? Are the firms themselves less cautious in their hiring of employees, screening of customers, or handling of accounts and cash? Do the self-regulatory organizations enact fewer or less stringent rules designed as preventive measures? If the answer to any of these questions is yes, then the trade-off for having insurance cannot be taken lightly.

While the present system is certainly not perfect, it has worked remarkably well for many years. The best insurance is a strong clearing organization, properly capitalized firms, and a sound self-regulatory framework with competent CFTC oversight that is effectively and consistently enforced.

On hedging, we stand for new definition, something more attuned to the financial markets. I know that other witnesses are going to cover this in greater detail, and I'll let my written statement be submitted for the record.

Position limits and aggregation—I know that's going to be covered as well by other witnesses.

Let me say a word about off-exchange transactions. The FIA urges the Congress and the Commission to be extremely cautious in considering any legislation or regulation in the very broad area of off-exchange transactions. There is clearly a legitimate role for the CFTC in enforcement of section 4 of the act, which requires that all futures contracts be traded on a designated exchange. It does not follow, however, that all off-exchange transactions violate section 4. There are a myriad of vitally important nonexchange financial transactions that cannot legitimately be characterized as off-exchange futures, and should not be. We fear that the easy way out for regulators would be to characterize these transactions in such a way—as off-exchange futures—to destroy these markets, which legitimately provide hedging and investment opportunities for large and knowledgeable participants. The interbank currency market, interest rate swaps, forward rate loans or deposits, cross-currency rate swaps, Eurocurrency loans with marketable caps, and many more financial transactions and arrangements provide corporate treasurers and financial officers with the flexibility to operate in their economically most efficient manner.

Audit trail—the CFTC published a final rule on January 14, requiring that each side of all trades have, on the trade register, an execution time identified to the nearest minute. The Chicago Mercantile Exchange and the Chicago Board of Trade have presented the Commission with a proposal for compliance with the Commission rule. We are very pleased with the efforts being made by the CFTC staff and Commissioners and representatives of the exchanges to develop this proposed system for the enhancement of the audit trail. We believe that this serious undertaking is a very positive step which should be a continuing process of improving a system by which a day's trading can be reconstructed. As technology advances and markets expand, the industry must strive to keep pace in all areas, including audit trail. The audit trail issue presents a highly technical problem whose resolution lies properly in the regulatory arena. We applaud the motives of the CFTC and look forward to continuing progress where the CFTC, FCM's, and exchanges can work together and foster greater public confidence in our markets.

On the NFA, we applaud the progress of the NFA over the past 3 years. It has proven itself to be a self-regulator, responsive to its oversight authority. We join with the NFA and the exchanges in opposing the CFTC's request for additional rulemaking authority over the NFA.

Mr. Chairman, the FIA appreciates this opportunity to present its views to the subcommittee. We offer the subcommittee the assistance of our staff and membership in the most important undertaking of reauthorizing the CFTC.

Thank you very much.

[The prepared statement of Mr. Damgard appears at the conclusion of the hearing.]

Mr. Jones of Tennessee. Thank you very much, John. I do appreciate your statement and I assure you that it will be read with a lot of interest a little later.

We have another vote. I hate to do this because of the witnesses, but I think I'm going to have to recess the subcommittee; and then, if Mr. Glickman gets back before I do, then he can call you back to the witness table, if you can wait. If that's agreeable, we'll stand in recess. I regret this, but we've got some very important votes today.

[Recess taken.]

Mr. Glickman [acting chairman]. Thank you. I apologize for not being able to hear your testimony; this place has been a little contentious this morning, but we're trying to get ourselves educated quickly.

Let me ask, first of all, Bob Wilmouth—let me first of all say what a terrific job we think that the NFA has done, and that you've carried out the mandate of Congress excellently. And I think the record should reflect that you've acted in accordance with what we've wanted to do, and so I just think that the experience with the NFA has been a positive experience and one that I think has helped to build confidence in the industry and, to a large extent, it's because of your personal interest in making sure that customer protection rules are implemented and a whole assortment of things that you've been required to do. And I just thought I'd mention that.

Mr. WILMOUTH. Thank you very much. I should probably point out that three of the members of the board of directors are also on this panel today, and it's to their credit and the credit of many other members of the industry that we have achieved what we have achieved.

Mr. GLICKMAN. Let me first talk a little bit about the audit trail. I don't know who wants to take these questions, but I think that we need to, one, ask the general question—and this may have been covered in your statements—but again, for the record, where are you with respect to complying with the CFTC's rules? And where do you expect to be by October 1?

Mr. MELAMED. Mr. Chairman, if I could begin to try to answer that, I'd like to clarify the position and perhaps clarify some of the confusion that has surrounded this issue. As you know, it's been a provocative issue.

At the present time, we at the Chicago Merc are satisfied that our understanding of the interpretation of 1.35g is such that it will not be interpreted in its narrowest sense. And therefore we believe very strongly that the proposal that we have made to the CFTC, which is the computerized trade reconstruction system, will be able to comply with the interpretation and requirements of their statute for an audit trail, and therefore we intend to proceed with the implementation of that.

In order to help clarify the understanding of the interpretation, I might submit for the record—with your permission—a letter from the Chicago Board of Trade and the Chicago Mercantile Exchange dated March 4, to the Chairman of the Commission, and a subsequent letter from the Commission to Senator Lugar by the Chairman of the Commission dated March 13, which refers to that letter. And I think between those two letters, they embody the present interpretation of this statute and the requirements.

Mr. GLICKMAN. That letter ought to be made a part of our record, and so it will be included—the March 13, letter from Susan Phillips, the chairman——

Mr. MELAMED. As well as the letter that it refers to, which is our letter to the Chairman.

Mr. GLICKMAN. Without objection, both letters will be included in the record.

Mr. MELAMED. Thank you.

[The letters follow:]

March 4, 1986

The Honorable Susan M. Phillips
Commissioner
Commodity Futures Trading Commission
2033 K Street, N.W.
Washington, D.C. 20581

Dear Chairman Phillips:

The Chicago Board of Trade and the Chicago Mercantile Exchange appreciate your assistance in arranging for an in-depth presentation on February 27, 1986, of our proposed Computerized Trade Reconstruction ("CTR") system. Attendance by Commissioners Hineman, West, Seale and Davis and CFTC staff underscores the CFTC commitment you stated, to "continue the dialogue which has begun."

We would also like to take this opportunity to clarify our letter of February 25th. Its tone was due to our misinterpretation of Regulation 1.35(g). As we now understand it, the Regulation is not to be read in its narrowest, most-technical sense. Therefore, we are certain that our CTR proposal will effectively meet its standards.

As you probably surmised from the enthusiasm of our presentation, we are convinced that CTR represents the finest audit trail system possible. It relies on sophisticated state-of-the-art computer technology and results in a remarkable surveillance tool for on-line analysis of trade data. Most importantly, CTR does not impair market liquidity nor diminish the speed of execution and confirmation.

The Honorable Susan M. Phillips
March 4, 1986
Page 2

In our opinion, the meetings were extremely constructive. We had the opportunity to respond directly to Commissioners' questions regarding CTR, to clear the air and to resolve our previous differences. We trust that the CFTC Commissioners and its staff agree with our view that we are now on a cooperative road to resolution of this issue.

In this spirit, we offer to continue to work with the Commission to achieve the audit trail result we mutually seek. We stand ready to respond to any further queries.

Sincerely yours,

CHICAGO MERCANTILE EXCHANGE

John F. Sandner
Chairman

Leo Melamed

Leo Melamed
Special Counsel

William J Brodsky

William J. Brodsky
President & C.E.O.

CHICAGO BOARD OF TRADE

John F. Gilmore Jr.

John F. Gilmore
Chairman

Thomas R. Donovan

Thomas R. Donovan
President & C.E.O.

cc: Commissioner Robert Davis
Commissioner Kalo A. Hineman
Commissioner William E. Seale
Commissioner Fowler C. West
Molly Bailey
Andrea Corcoran
Dennis Klejna
Kenneth Raisler
Paula Tosini

COMMODITY FUTURES TRADING COMMISSION
2033 K Street, N.W., Washington, D.C. 20581
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Susan M. Phillips
Chairman

March 13, 1986

The Honorable Richard G. Lugar
Chairman
Subcommittee on Agricultural Research,
  Conservation, Forestry and General Legislation
Committee on Agriculture, Nutrition
  and Forestry
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Thank you for your kind letter of February 20, regarding the Commission's audit trail rule and capital proposals as well as the timetable for Senate consideration of the Commission's reauthorization bill.

Enclosed for your information is a March 4, 1986 letter from the Chicago Mercantile Exchange and the Chicago Board of Trade regarding their proposed Computerized Trade Reconstruction ("CTR") system and a recent version of the CTR proposal. The Commission agrees with the description in the second paragraph of the exchanges' March 4 letter of the requirements of the Commission's audit trail rule. Based on the exchanges' representations of the time and sequencing accuracy of their trade reconstruction system, their proposal has the capability of meeting the standards of the rule. The Commission stands ready to assist the exchanges as they more fully develop the technical aspects of their proposals. In addition, the system would, of course, be assessed as part of the Commission's regular oversight responsibility.

With respect to capital, in response to a request by the Futures Industry Association, the Commission recently extended the comment period on its capital proposals until April 4. We understand that several industry committees are developing alternative capital proposals. Since any capital rule changes would have to be reproposed for public comment if there are significant changes, as are currently contemplated, this issue also is not likely to be resolved completely in the near term.

The Commission respectfully requests that this letter, the enclosures referred to herein and a chronology of events surrounding the audit trail we have prepared be considered as a report on this issue requested by the Committee at the recent hearings, and that they be inserted in the record of my testimony at the appropriate place.

Sincerely,

Susan

Susan M. Phillips
Chairman

Mr. GLICKMAN. Does anybody else on the panel care to discuss the audit trail issue?

[No response.]

Mr. GLICKMAN. Let me go to Mr. Sandner. I am aware that the Chicago Mercantile Exchange will make a proposal on CFTC rulemaking, and perhaps Mr. Melamed may want to talk about this or somebody at the CMA, but I wonder if you would elaborate a little bit about your feelings with respect to the operation of the Commodity Futures Trading Commission and the rulemaking process?

Mr. SANDNER. Well, to be quite frank, Mr. Chairman, we feel at odds with the CFTC on the rulemaking process. We feel that the Commission does not take the care and the time to analyze the substantive effects that their rulemaking will have on the industry. We feel that they don't properly weigh the cost of the regulation relative to the benefit to the industry. We feel that they don't properly communicate and enter into constructive dialog with the industry to find alternatives which are much more cost benefit related. One example that I had given in my testimony was the capital rule promulgation.

I had indicated that the capital rule promulgation was precipitated by the Volume Investors failure several months ago—1 year ago; I don't know the exact date—but anyway, through the CFTC's own investigation and other investigations it was determined that that default or that failure was really the product of—not poor capital rules in the industry, but rather a violation of existing regulations. Nevertheless, the CFTC went on and promulgated the capital rule without taking the time to enter into the dialog necessary to come up with an adequate rule, if it was necessary at all.

That rule was basically a knee-jerk reaction based on the failure of a firm for which, I might add, all the customers have been made whole as recent as 6 weeks ago or so.

But in any event, we feel that's an example of poor regulatory exercise, and that we would like the CFTC basically to invoke the same safeguards we would invoke when we promulgate rules, and that's to weigh the cost benefit of the rules.

Mr. GLICKMAN. But are you going to propose a specific modification to their rulemaking?

Mr. SANDNER. Yes.

Mr. GLICKMAN. And will that proposal be a part of this legislative proceeding in the reauthorization process? Or is this going to be something that you're going to propose as a part of their general rulemaking procedure internally?

Mr. SANDNER. If I might, I'd like to confer with our attorney.

It's part of this reauthorization, our legislative proposal.

Mr. GLICKMAN. OK. As I said before, I happen to serve in two hats on this. I chair the appropriate Judiciary subcommittee with administrative rulemaking authority, so I'd like, if possible, that you share that as soon as possible.

Being candid with you, I've been a little bit suspect of this kind of process on an across-the-board basis because I'm not sure that you have two equal parties. The purpose of the law is to have two equal parties negotiating with each other. I think that there has to be appropriate consultation, but it's not like two private parties negotiating with each other, either.

So I'd urge you to share that with us as quickly as possible, for us to take a look at it.

One final question, and then maybe we'll come back. I know that the Chicago Mercantile Exchange has a $30 million indemnity fund to protect against losses, and I think the Chicago Board of Trade has established a similar type fund recently. I don't think it's as large.

I have been concerned for some time about the fact that customers in commodities firms—their accounts are not insured by the Federal Government as are customers in the securities firms. And I think Mr. Damgard has referred to this problem in his testimony about customer account protection. But I think it's useful to have you all here as people who are involved in the industry, particularly after the Volume Investors situation, to talk about the current state of customer account protection. Are customers' accounts safe? And is there proper liquidity in the industry itself to take care of any customers' losses that would result? And anybody that wants to answer that question, can.

Mr. SANDNER. I'd like to—I chaired the Customer Account Protection Committee at the NFA, and the preliminary study has been prepared. And I believe the copies have been presented to various people interested in the issue. I would, however, like to defer the question to Bob Wilmouth, who is president of the NFA, and if there's anything that you need that Bob doesn't answer, I'd be glad to answer your questions, Mr. Chairman.

Mr. WILMOUTH. Let me just say that we have submitted a 60-page report, plus appendices, to the CFTC and I believe that is going to be the subject of discussion at an open Commission meeting sometime around the middle of April.

The report is the result of—although we've had the study given to us for 6 months, we've really only been at it about 4 months—it's the result of a culmination of a lot of efforts on the part of NFA staff to kind of define the problem, to take a look at risk analysis, to analyze the various methods of risk reduction, then to take a look at some of the alternative possibilities in response to an insolvency problem that might occur in this industry, some of the methods necessary to provide resources to respond to that insolvency, how to generate income, and things of that nature.

This is a preliminary report and needs further refinement and study, but I think I would like to just read, if I may, four or five lines from this study, which is supportive of what John Damgard has said and which I think is important in response to your question when you compare SIPC and some types of Federal insurance for securities customers and the lack thereof for commodity customers: "There has never been a default of a domestic futures clearing corporation"—I think Jack Sandner emphasized that point in his testimony—"although there have been customer losses as a result of FCM failures. These losses, between 1938 and 1984, have amounted only to approximately $10 million. In contrast, during SIPC's first 14 years, from 1971 to 1984, it distributed approximately $153 million to securities customers. Therefore, SIPC has, on the average, paid out over $10 million to customers each year."

The other point that I think I would like to make is that we're not necessarily certain that, in terms of customer account protection, insurance in effect is the answer. In the futures business, the answer for certainly most commercial hedgers and participants in the marketplace could very well be the transfer of an open position to another FCM. And those are the types of things that we are looking at.

We have a well-represented committee chaired by Jack Sandner of the Merc and encompassing all segments of NFA population, and we will continue to work and refine the study as time goes on.

Mr. GLICKMAN. Well, I would thank you. My time has run out. I remain interested in the customer account protection area, but I am aware of your NFA report. I think it does outline the problems with a pure SIPC type insurance as it relates to the futures industry, so I'm not going to press that specific solution this authorization period, but I would just encourage you to keep your options open as it deals with the issue of customer account protection.

Mr. Coleman.

Mr. COLEMAN. I don't know which one of you from the Merc would like to answer this, but in your proposal that you have made regarding your tracking system, does that include the sequencing of the trading cards that your people use in the pits?

Mr. MELAMED. Yes; it does.

Mr. COLEMAN. OK.

Mr. MELAMED. And that, of course, will help implement this system and help the iterations that the program that will call for in checking back, when the transaction occurred.

Mr. COLEMAN. Do you anticipate between now and October 1, running real figures through your system to be able to display and exhibit all of the information that the Commission might need in order to, I suppose, give its seal of approval, if this is how we're going on this? How do you envision exhibiting this system that you have?

Mr. MELAMED. Well, ultimately, of course, the system will exhibit itself each morning when—the next morning will show a reconstruction of the previous day's trade, with each trade having a sequence time against it; that is, the time that trade occurred.

But to the extent possible, we'll have the system in place as soon as we can. It's a question of programming. It's a hard job to do; it's also going to take a lot of time to put all the elements into the system. This can't be done piece by piece because they all integrate together. So I expect we will begin to work at it quite shortly, and hopefully it will be in place as soon as the CFTC wants us to have it in place.

Mr. COLEMAN. Now, Mr. Brody, you've been somewhat quiet on the audit trail issue. Is COMEX going to be able to adapt or adopt the same system, or will there be a different one for your exchange?

Mr. BRODY. As far as we're concerned we are, first, watching very carefully the progress of what it is that the Chicago Merc and the Chicago Board of Trade have submitted to the CFTC, and to try to ascertain exactly the way the CFTC is intending to enforce the new 1.35 requirement, and then we're going to attempt to see what it is that we can do in New York where, as I think I mentioned in my testimony, there are some subtle differences in our trading system. So we could not implement exactly what they've described that they're going to implement in Chicago, but we're going to look toward what they're doing there to see how we can tailor it to our system and then move forward from there.

In short, we don't know exactly what we're going to do now, but we're watching the situation and studying it internally to see what we intend to do.

Mr. COLEMAN. OK.

Mr. Wilmouth, one of the scenarios regarding leverage has to do with involving NFA in the possibility of increased responsibilities and taking the moratorium off. Ms. Phillips indicated in her testimony that she felt that the Commission did not have the authority to require you to do this, but that it would take congressional action.

I was wondering if you might be able to tell us what your current attitude is on that possibility? And if we were to—or if the Commission were to ask you to do this, what would be your response? And generally respond to that possibility of involving your association in these activities.

Mr. WILMOUTH. Certainly. NFA, as you know, is a voluntary organization, and the board of directors at any time can decide whether to expand the definition of instruments that are subject to NFA regulation and put them underneath our authority and power. So certainly, if the leverage issue was raised with us through a request from the CFTC, I think the board of directors will do collectively whatever it determines is in the best interest of the public and the membership.

But if I might add, I think there is really a bigger issue at stake here that was brought out during—I think it was Congressman Daschle's dialogue with Chairman Phillips this morning. We are concerned at NFA with what I would term the wholesale frauds in the sale of contracts which fall outside the definition of legal leverage contracts. To fall outside of that definition, there are all types of exotic things that you can do and we've got all types of contracts out there called "deferred delivery," "cash forward," "fixed cost," "fixed maturity," "cash forward," whatever it happens to be.

And what we are concerned with is that the leverage industry is shadowed by kind of an underground commerce, I think is the word that Alan Brody used, in leverage contracts. And some of these contracts are specifically structured to fall in between the regulatory cracks, to fall into regulatory limbo, as it were. And we don't want our good name to be damaged through association in the public mind with fraudulent businesses which, because of legal distinctions, NFA cannot regulate. But we think that the CFTC is doing what they can do in that particular area, and in combination with their efforts—and hopefully, although it seems to be moving rather slowly, the adoption by the States of this Model State Commodity Code which the North American Securities Administrators Association have put together—that will go a long way toward, I think, beginning to cure the problem and to wage effective combat, so as to speak, against the shadow-type or underground-type leverage.

We don't want to really be associated with it when it has that connotation with it; but certainly, if it's brought to us, we will have our board of directors examine it as a voluntary organization and make a determination which we think is in the best interests of our members and the public, because that's our job, to protect the interests of the public.

Mr. JONES of Tennessee. Thank you, Mr. Coleman.

Mr. Gunderson, if it's OK with you, I'd like to follow up on what Tom has just been discussing, and let me ask John Damgard a question or two.

John, in your statement you mentioned a number of off-exchange transactions such as interest rate swaps, forward loans and deposits, cross-currency rate swaps, and some others. And I don't know much about these transactions, and I'm wondering if you would be willing to tell us if these transactions are regulated by CFTC or any other Federal agency?

Mr. DAMGARD. Well, Mr. Jones, I have to confess that I don't know a whole lot about them, either. I have with me, however, Jack Lehman who deals with these types of products on a daily basis as the head of the commodity department for Shearson, and we also have Gary Seevers of Goldman, Sachs who spoke on the subject, I think, on the Senate side. So with your permission, I would like to defer to either of those two gentlemen; noting that, of course, many of these types of instruments are proprietary in nature, and I doubt that it makes them terribly comfortable discussing in great detail what their particular firm has designed to meet the needs of a particular customer, for competitive reasons.

There, Jack, I think I've put you in a tough enough spot.

Mr. JONES of Tennessee. Mr. Lehman.

Mr. LEHMAN. I think what we're talking about here are large transactions that are specific in nature; they may occur as part of a larger principal transaction. They may occur at times that the markets are closed, and they are essentially between the firm as a principal and a large, sophisticated, generally institutional customer.

I might add that to the extent that we, as a firm, take a position versus a customer, we in turn generally will hedge our own exposure on the futures exchanges.

I don't know if that entirely answers the question, but that's the meaning in the report.

Mr. JONES of Tennessee. John, do you have anything to add to that?

Mr. DAMGARD. No; I don't. I do see that Gary Seevers is up on either the next panel or tomorrow—that may be the same thing—and Gary, I know, is intimately familiar with what Goldman, Sachs does in this area, and I would yield to Gary.

Mr. JONES of Tennessee. Is Gary here? Is he onthe next panel? OK. Well, we'll defer for the sake of time.

Well, if these are not regulated, should they be regulated, John? Could you answer that?

Mr. DAMGARD. In my judgment they do not need to be regulated unless it's demonstrated that they've created some kind of a problem. And to the extent that the people engaged in these kinds of transactions are, indeed, very, very sophisticated, and in most cases institutions, I think they go into these transactions knowing the risks and knowing precisely who they're dealing with. And therefore, in my judgment, I think it's unnecessary that they be regulated, certainly by the CFTC.

Mr. JONES of Tennessee. Does any other member of the panel want to comment on that?

[No response.]

Mr. JONES of Tennessee. John, if you would, then, since you're close by and we see you pretty often, if you'd submit to the subcommittee a report of these and any other such transactions which would be identified, and define each type of transaction, I'd appreciate it very much, if you'll do that.

Mr. DAMGARD. I'll be happy to do that.

[The material follows:]

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April 14, 1986

The Honorable Ed Jones
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

The Futures Industry Association is pleased to submit the attached supplemental statement you requested during hearings on the reauthorization of the Commodity Futures Trading Commission.

Sincerely,

John M. Damgard

John M. Damgard
President

The Futures Industry Association is pleased to respond to the request of Chairman Ed Jones for further information on off-exchange financial transactions, specifically, interest rate swaps, forward rate loans or deposits, cross-currency rate swaps and Eurocurrency loans.

These are just a few of the myriad financial transactions being used by corporate treasurers, banks and institutions to manage their businesses in the most efficient manner. These markets are constantly evolving, maturing and developing in response to the needs of the corporate world. Transactions such as the few described below may be at the cutting edge of finance today, but will most surely be replaced by newer means of financing and risk-shifting in the future.

As a general matter, these are transactions between a financial firm or bank and sophisticated or corporate/institutional customers. They have been developed, with many variations, in response to customer's demands for protection from the risks of changing interest rates and foreign exchange volatility. They are not standardized contracts, but are created at the time the transaction giving rise to the exposure actually occurs, or very shortly before. The terms of such agreements are individualized to accommodate a specific dollar or time exposure that may not correspond to any futures contract currently traded.

In some instances, these are unregulated markets whose participants (banks, pension funds, brokerage houses) are regulated by various state and federal agencies including the Securities and Exchange Commission, Comptroller of the Currency, Federal Reserve Board, and Department of Labor. (see Attached letter from the Federal Reserve Board to CFTC General Counsel).

Interest Rate Swaps:

Interest rate swaps are a mechanism by which the risk of dollar interest rate fluctuations can be shifted. An interest rate swap is generally a bilateral executory promise or contract between two parties to exchange an obligation to make fixed rate payments for an obligation to make variable rate payments on a sum of money. In other words, a party with a variable rate commitment can exchange it for a fixed rate commitment and vice versa. For example, a savings and loan association often will have a fixed rate loan portfolio (asset) and deposits (liability) on which it pays interest at a floating rate. To match the asset with the liability, the S&L would enter into a swap agreement to pay a fixed interest rate on some notional amount (e.g., $20 million) and receive interest at a floating rate (Libor or prime plus X%) for a fixed period of time. With respect to the rates, the S&L would want to pay the fixed rate it is receiving and receive a floating rate in excess of the amount it must pay depositors. The purpose of the exercise is to lock in a fixed return.

Swaps are not fully standardized but are customized to fit the needs of the parties, one of whom is almost always a professional, usually a bank. Swaps are more flexible than futures in a number of ways. Significantly, a futures contract has a life of no more than 18 months while a swap arrangement can be many years in duration. The U.S. market dominates the business in short-term interest rate swaps of one to three years (probably 60% of the total volume). Much of this business is handled by arbitrageurs, who hedge themselves with futures and options. The long-term swap market of five to twelve years is more evenly split between the dollar and five or six other currencies, and the total volume in non-dollar swaps probably runs at about $30-40 billion a year.

Currency Swaps:

Foreign currency swaps began in 1977 as a way to shift the risk of dealing in a particular foreign currency. For example, assume an entity has a floating rate liability payable in pounds or tied to pounds, and assets (e.g., accounts receivable) payable in dollars. The entity, for business planning reasons, would prefer to have a fixed rate obligation and not be subject to exposure as the result of the pound becoming expensive relative to the dollar. The entity would agree to pay a fixed rate payable in pounds in exchange for a floating rate payable in dollars.

As another example, assume that a U.S. company wants to borrow $100,000,000 for ten years. The best rates are Eurobonds at 10 3/4% and Swiss Francs at 4 1/2%. The U.S. company wants dollars. At the same time, a Swiss company which has saturated the Swiss market needs to borrow a like sum. The U.S. firm does the Swiss Franc borrowing, the Swiss company borrows Eurobonds, and they swap.

Eurocurrency Loans:

This typically consists of borrowing in a foreign currency to take advantage of lower interest rates in Europe coupled with a hedge in the forex market. The forex market might be used rather than the futures market because of greater liquidity, lower cost, the ability to match the hedge specifically against the loan (e.g., five years and six months) and, if the borrower has a sufficient credit rating, the ability to avoid variation margin payments.

Forward Rate Loans or Deposits with Marketable Caps:

These are arrangements which control how high or low the interest rate on a loan or deposit can move.

A recent New York Times article describes a typical cap transaction: A corporation wants to raise capital at the cheapest possible rate. Its investment bank arranges for it to sell $100 million of 12-year floating-rate notes on the Euromarket. The notes come with a cap that limits to 12.75

percent how high the interest rate can rise. Normally the corporation could have borrowed the money at one-eighth of a percentage point over the London Interbank Offer Rate ("Libor"), currently at about 8%. But because the cap limits the potential return to the buyer of the notes, the issues has to offer a slightly higher interest rate to attract buyers. Thus, the notes are offered at three-eighths of a percentage point over Libor.

The investment bank then buys the cap option back from the issuer for a lump sum. Even so, the investor who has bought the notes will still only receive a maximum of 12.75%, even if the market rates should rise higher. But the issuer has decided to forego the protection that the cap had provided. Instead, the sum it received effectively lowered its interest payments by the equivalent of one-half of a percentage point on the $100 million in debt, or to one-eighth of a point below the Libor rate.

Meanwhile, the investment bank has located a corporate customer with $100 million of floating-rate debt on its books and that is anxious to protect the debt against a dramatic increase in interest rates. The corporate customer buys the cap option from the investment bank, presumably at more than the investment bank had paid.

Mr. **Jones** of Tennessee. Does any member of the subcommittee have any comment on this subject?

If not, I yield to Mr. Gunderson for whatever time he needs.

Mr. **Gunderson**. Thank you, Mr. Chairman. And rest assured, any time you want to step in and talk, you always have the right to do so.

I'm going to ask some very simple questions, but I would be remiss if this panel would leave us today in the reauthorization process without some comment.

First question I would like to ask—and I'm going to name both of them first so you guys can use up as much time as you want in responding—what, in your opinion, is the most important issue that we must resolve in reauthorization? Please prioritize.

Second, as Mr. Sandner indicated and I wholeheartedly agree, if you look at the farm bill of 1985 we are clearly moving toward a market-oriented agricultural economy in almost every sector of agriculture. I would be interested in what those of you who have exchanges that deal with agricultural commodities will be doing to try to facilitate the use of your commodity exchanges by small- and medium-sized family farms in this country, educating them as to both the ability and the need to participate in your futures markets.

Open to any comments from any of you on those two issues.

Mr. **Sandner**. Congressman, I'd like to address the second question.

Mr. **Gunderson**. Sure.

Mr. **Sandner**. Our exchange has—first of all, we have created new products to offer these risk management tools to the agricultural community. Second of all, our feeder cattle contract—at our exchange, for example, we've changed that contract to a cash settlement contract, and that's been approved by the CFTC. We're going to apply—when we're allowed to apply—for a feeder cattle option contract.

But putting that aside for one moment, we can develop all the products in the world, and someone has to educate the farm community about those products. And so what are we doing about that? At our exchange, we have a committee called the Agricultural Steering Committee, and that committee has been shored up as recently as 1 month ago with some very high-powered, highly energetic, highly knowledgeable individuals in the agricultural world at our exchange.

In addition, we have recently formed—are still in the process of forming—an Agricultural Advisory Committee which will be comprised of 10 to 15 nonmember agriculturally expert individuals in the agricultural community. We will have regular meetings with this committee and take suggestions and work hand in hand with that particular committee to develop tools to bring our agricultural world in focus with their agricultural world.

One of the things I think we have to do, when you talk about the small farmer, that's the individual—that's the audience—that has to be educated. And it's very difficult for an exchange or two exchanges to send out hundreds of experts on these products to teach all the farmers. One of the approaches we're going to take is to address, through seminar fashion, many of the banking and financial institutions, because it is those institutions that have the communication and the dialog with that community in their area. And once we educate the bankers, many of whom are already educated, but once we educate the bankers they can then transfer that education and expertise that they've picked up from us to the farm community.

We know it's a pressing issue. We know we have a big job to do, and we're happy to do that job. And we're going to look to the banking community and the financial institutions around the country and in the agricultural sector to help us with that.

Mr. GUNDERSON. Quickly, before my time's up, can each of you name what is the top priority for reauthorization? Just name the issue.

Mr. WILMOUTH. I'll name an issue for NFA, if I can.

Mr. GUNDERSON. Sure.

Mr. WILMOUTH. NFA is vehemently opposed to the CFTC proposal which seeks to overrule the voluntary nature of our organization. That is crucial to our continued existence, that we can do it voluntarily; without that, the $36 million that this industry has spent is going to be in trouble for the future.

Mr. GLICKMAN. Would the gentleman yield just one moment on that issue?

Mr. GUNDERSON. If I can get more time, sure.

Mr. GLICKMAN. I wonder if Mr. Wilmouth would respond whether the SEC has the authority over the NASD rulemaking process that you do not wish the CFTC to have on your process?

Mr. WILMOUTH. Yes; they do have, if I understand your question correctly.

Our concern is a very simple one, is that in 3 years, starting from scratch, this industry has poured $36 million into voluntary self-regulation. We've done our job. This can't be a remedial measure on the part of the CFTC because they've admitted that we've done the job. It can't be to put us on a parity with the exchanges—where they do have this authority, by the way—because we're not an exchange. We're not in—we don't have the same interests as the exchanges have. Congressional oversight over us is different. Every single issue that has come up—customer account protection, we're working on right now. We've done a "know your customer" rule. We've done discretionary account supervision rules. We've done disclosure fees. We've done everything. And to now, all of a sudden, to become a division of the CFTC, the self-regulation division of the CFTC, doesn't make any sense to us at all.

So in response to the general question, that is our big concern.

Mr. GUNDERSON. Alan.

Mr. BRODY. Mr. Gunderson, if I could just respond very quickly to the first part of your question, which is, what is the most important issue—I think the folks from the Merc want to speak also—from my perspective, and it's an issue that I've been on top of for some time, it may come as no surprise. I think the most important thing for this committee to do in this reauthorization is to once and for all address this issue of the off-exchange futures market, the so-called leverage issue.

Very quickly, I empathize very well with the sentiment implicit in the chairman's question earlier this morning of Susan Phillips when he mentioned the fact that this has been addressed in 1974, in 1978, in 1982. Well, that's quite true, but it's not going to get any easier to resolve if we let it go this time, and it's my hope that we can in fact resolve it in this reauthorization.

Thank you.

Mr. MELAMED. Clearly, for the Merc and the larger exchanges, the pressing and most important issue on a priority basis is the audit trail issue, as we've testified and as is clearly of most concern to us. That doesn't really mean that there aren't some other pressing issues, as you've heard, but in terms of priority, that's No. 1.

Mr. GUNDERSON. I just think it's fascinating—three different answers from three different people, which is enlightening.

My time is up. Thank you.

Mr. JONES of Tennessee. Thank you very much, Mr. Gunderson. If you need more time, you can certainly get it later.

Mr. Evans, you are recognized.

Mr. EVANS of Illinois. Thank you, Mr. Chairman.

Mr. Brody, to pick up in regards to your most pressing concern, how would you respond to the suggestion that the exchanges simply are attempting to eliminate a very tough competitor, to put that competitor out of business?

Mr. BRODY. Well, Mr. Evans, there's no question—let me say at the outset, in responding to your question—that the Congress and any regulatory agency of the Congress ought to be very, very sensitive about arbitrarily—and I emphasize the word "arbitrarily"—putting somebody out of business, whether it's a competitor of mine or anybody, for that matter. But that really, I don't think, is the issue here. The fact of the matter is that the proposals that have been outlined, both by the CFTC in the bill that they've put forth in the Senate as well as H.R. 3434 in my judgment, frankly, would not put anybody out of business. As I alluded to in my testimony, there are other "legitimate" businesses for some of the leverage merchants to be in or, for that matter, any other party that wants to get into some aspects of the futures business, including the selling of futures contracts.

And finally, I would suggest that—the fact is inescapable that leverage contracts are futures contracts. I think that's been testified to today by the Chairman of the CFTC, and I made that statement in my testimony. The fact of the matter is that futures contracts, under law, are required to be traded on exchange with the benefits of a self-regulatory system, a clearinghouse—the integrity of a clearinghouse, competitive pricing, and so on and so forth. If today COMEX unilaterally stopped having an open auction market and had no economic benefit to any of its contracts, I suspect that somebody would try to put us out of business, specifically the CFTC, and I would submit that nobody on this committee would be bothered.

So the fact is if they are futures contracts, they must be made to comply to the same rules of the game that the futures exchanges comply with; and if the result is that they go out of business—that particular business—so be it.

Mr. EVANS of Illinois. All right. Well, does the success of NONEX and the other leverage firms show that there's a public interest in having smaller and more flexible futures contracts than those offered by the exchanges?

Mr. BRODY. Not in my opinion. My judgment is that — well, I think as the law so states and as this committee, I believe, would reiterate and I would repeat, what's in the public interest is a futures market, or futures markets generally, that serve economic purposes, that serve commercial functions, that are guided by competitive pricing in open outcry market, and some of the things that I just mentioned in my prior response. That's what I think is ultimately in the public interest, and that is not—all those items are not what characterize the leverage business.

Mr. EVANS of Illinois. All right. Thank you.

Thank you, Mr. Chairman.

Mr. JONES of Tennessee. Thank you very much, Mr. Lane Evans.

Now, Mr. Cooper Evans, you are recognized.

Mr. EVANS of Iowa. Thank you, Mr. Chairman.

I would like to pursue the subject of the audit trail just a little bit. I wonder if Mr. Sandner or Mr. Melamed could describe for me in a little more detail the function of the cards today, the trading cards, and how that would be changed under the computerized system that you're proposing.

Mr. MELAMED. I'll be happy to, Mr. Evans.

Actually, that portion of the computerized trade sequence reconstruction system that we've offered is only a small, small segment of the whole system. Actually, most of that will depend on systems that are already in existence by virtue of computerized recordation that goes on. The sequencing of cards is such that it will aid that process by requiring every firm on the exchange to pick up from its local traders, during the course of a given day, the cards; and that the cards will be in a sequenced order by virtue of the fact that they will be pre-sequenced so that each trader will, in fact, be trading and recording the trades on a sequenced card so that we know that the trades occurred in the order that the cards are submitted.

Mr. EVANS of Iowa. Do you have a—cards are used to some extent right now? Is that right?

Mr. MELAMED. That's right.

Mr. EVANS of Iowa. And so you would still be using cards?

Mr. MELAMED. We would be using cards, but they would be presequenced.

Mr. EVANS of Iowa. They would have a number printed on them before they went to that trader?

Mr. MELAMED. Precisely.

Mr. EVANS of Iowa. How often would you pick these up?

Mr. MELAMED. We expect to pick them up once during the trading session and once at the end.

Mr. EVANS of Iowa. Is there a difference in how a floor trader would record or use the cards or sequence the cards if a trade was for his own account?

Mr. MELAMED. We are speaking for those who are trading for their own account because the other is a time recordation that occurs on a public order. It occurs at the time of entrance immediately, anyway, and at the time of exit as well. So we are talking about a trader who is trading for his own account and is using those trading cards to record that transaction. He doesn't have a public customer order on which to record the transaction; he does it on a trading card.

Mr. EVANS of Iowa. What is your reasoning for only picking those up once during the trading session and once at the end, rather than at more frequent intervals?

Mr. MELAMED. It's part of a whole process that will require a lot of experimentation because it's a big change in terms of creating this process for it to work. It's not merely a question of picking the cards up; it's also a question of putting them into the computer. And we know that we're all working toward a more rapid system of computerization where all of this can be going on during the entire course of the day. But really, that the system cannot take but one time in the middle of the day because of the enormous influx of trade that will be going on all the time by the clearing firms. We don't expect that it can be done more than one time until we get used to it. During the course of time, we will probably try to do better.

Mr. EVANS of Iowa. Well, I would not disagree with that, I guess. It just seems to me that even with presequenced cards, that there is a possibility of traders using them out of that sequence or filling them in, and that more frequent pickups would be desirable even if you didn't get them entered into the computer system at that particular point in time. And I guess I would feel a lot more comfortable if those cards were collected from the floor or turned in or a runner picked them up or something every 30 minutes or every hour or whatever, at considerably more frequent intervals.

But to what extent are you going to be able to identify the times of those trades for one's own account? I think there is more difficulty with that than trading for another customer, right?

Mr. MELAMED. That is correct.

Mr. EVANS of Iowa. And you're going to have a little bit of trouble within the system getting everything matched up according to time, particularly those kinds of trades; is that right?

Mr. MELAMED. The trade—when it is a trade with a public customer, it will be a lot easier to find the exact time of transaction as a trade between two locals that doesn't have a time of entry because the time of entry occurred in their heads. And so, clearly, that will be more difficult to do; and yet we feel that we will get a reasonable exactitude of when those transaction occurred.

Mr. EVANS of Iowa. It's my understanding that this general subject is one of some sensitivity, but from your discussion it would seem to me that one could go ahead with the expensive part of doing the CTR system, and that there would be some subsequent flexibility in just how those cards were handled. Is that true, or am I not understanding the processes?

Mr. MELAMED. Well, I think much of it—you do understand it well, and I do think that much of it we're going to learn as we go along, to what extent we can push this system and how it will work even better. We're obviously going to try to do the best that we can with it, and we will learn as we go along. It's a major step, as you will recognize, one that we will have to get comfortable with. But we will do the best we can in making it even better.

Mr. EVANS of Iowa. You're not insisting, then, at this point—if I may continue for a minute, Mr. Chairman—you are not insisting, then, at this point that the CFTC bless forever your present proposal on how you handle these cards as a condition for going into that——

Mr. MELAMED. What we are asking is that the CFTC bless the fact that CTR complies with the regulations for an audit trail as they have promulgated them, with all the complement that it includes. And we will do the best we can in responding to how the things within CTR are to work.

But yes, we are asking the CFTC to bless the CTR system as one that they think contains the elements that will satisfy the regulation. And I think they have said that.

Mr. EVANS of Iowa. Thank you, Mr. Chairman.

Mr. JONES of Tennessee. Thank you very much, Mr. Evans.

That completes the round, and I believe Mr. Glickman has at least one question.

Mr. GLICKMAN. Yes. I would just ask one question, and then a comment.

Bob—Mr. Wilmouth—you're going to have to give me a lot stronger argument why the CFTC should not have the same right that the SEC has with respect to this 17-K-2 issue because all you've basically given us to date is that we're young, we're good, and we've done what we were supposed to. But that's not a good enough argument because the CFTC has this power with respect to exchange rules; as I understand it, they've used it only twice in their history.

Mr. WILMOUTH. They've used it three times in their history, Congressman. Twice with respect to contract market designations—with respect to contracts on designated markets—and the other time, I believe, was in arbitration.

I don't see an analogy there, if that's what you're trying to draw, because——

Mr. GLICKMAN. Well, the fact of the matter is that even as a self-regulatory organization, one could argue that the exchange is a kind of a quasi-self-regulatory organization as well, and I—you know, I suppose if there is good reason to separate the method of securities regulation from commodities regulation, it ought to be done. And I have agreed with you conceptually on the issue of insurance, that we have different problems there. But I don't see any difference on this issue.

Mr. BRODSKY. Mr. Glickman.

Mr. GLICKMAN. Yes?

Mr. BRODSKY. If I could assist a little bit, I think there is a major distinction between the NASD and the NFA, and that is that the NASD looks more like an exchange; the NFA does not at all. The reason is that the NASD maintains a marketplace and, in fact, competes vigorously with the securities exchanges and, as you know, in many respects does as much volume on some days as the New York Stock Exchange. The NFA maintains no marketplace, competes with nobody, and therefore is the only pure regulatory organization—and, as Mr. Wilmouth says, a voluntary one—in both industries. And I think that that's a meaningful distinction that ought to be examined.

Mr. GLICKMAN. It may be a distinction without merit; it may be a distinction with merit, but they both do a lot of the same things.

And I don't want to go down the road where we have a huge fork in the road and you're talking about how you regulate and relate between brokers and FCM's and the public, that you have two entirely different methods of doing it.

All I'm saying is—I don't want to argue about the issue now. You haven't given me a good reason against it.

Mr. WILMOUTH. Well, I guess the only other reason I can give you is that it seems to me that the CFTC, within its own powers now—if they want to alter some of our rules, and let's take minimum financial requirements—right now, all they have to do is to alter their own, because we must maintain the same minimum standard that they do. So they can require us to alter ours merely by altering their own. And whenever they feel that the ethical guidelines that we have adopted are inadequate, they have the ability and they have the authority to remedy any shortcomings that they see in what we have by altering their own and through the rulemaking process. They have everything they need right now, is my basic answer, and there's no need for anything additional, particularly—and I admit I'm repeating myself—but particularly when it's worked, and worked so well.

Mr. GLICKMAN. OK. All right. We'll have to talk about this more.

The other question is, some time ago I expressed some concern about public board members on the exchanges. And I think that, Jack, you were talking about some of your advisory units. I wonder if—we have two exchanges here. How many outside or public board members do you have now, and how many have you added, and how many do you expect to have?

Mr. BRODSKY. I'll be happy to answer on behalf of the Chicago Mercantile Exchange. The Chicago Mercantile Exchange has six outside board members. These are not elected; they are appointed by the Chairman of the Board because it's our view that the members of the exchange really don't have a way of knowing who these members are. And it's our policy to try to reach out in a broad way—not only representatives of the public, but those who are associated with brokerage firms who are not actively members themselves. We have people such as Gary Seevers who is a former Commissioner of the CFTC and now vice president in charge of commodities of Goldman, Sachs who is one of our outside directors. We also have public directors, such as Jo Ann Smith, who is the immediate past president of the National Cattlemen's Association. It's our view to try to get a good—a broad view of people on the board from various disciplines with a view that they can help in many ways, and these people are full voting members of the board.

Mr. GLICKMAN. How many total directors do you have?

Mr. BRODSKY. We have 28 total.

Mr. GLICKMAN. OK. What's your intention in terms of the future? Are you going to intend to try to pursue getting competent outside or public members that maybe don't have——

Mr. BRODSKY. There's no immediate plan. We feel that six directors has been a very effective way of getting good input from the outside, and we intend to continue that.

Mr. GLICKMAN. Jack has a comment, and then I'd like Alan to respond, too.

Mr. SANDNER. Congressman Glickman, first of all, let's talk percentages. That's about 25 percent of our board that's comprised of public members. But something that you didn't really ask, but I think you ought to know, because very few people do know, our Business Conduct Committee—which is a very critical committee at the Exchange—now has a public governor serving on the Business Conduct Committee. So it's not a pure, exchange-member-run committee.

Mr. GLICKMAN. Excellent.

Alan.

Mr. BRODY. Mr. Glickman, at the COMEX we have a total of 25 directors, of which there are four slots a la the Chicago Merc that are appointed by the board. Currently there is a vacancy in one, so there are three of those slots filled. Two are what I would describe as genuinely public directors. One is Andrew Brimmer, a former govern~~or of~~ the Federal Reserve Board; the other is Eric Peter Bieri, who is the president of an international trading organization, not a member of COMEX. The third is what I would describe as a member of COMEX but having no particular affiliation in any of the member constituencies.

Our experience with public directors has been a good one. Although we have no current plans to increase the eligible slots for public directors, we intend to fill the vacancy, it is my hope, at some time in the future. And we have found that public directors serve a very good and valid purpose. We have placed them on a number of instrumental committees, including disciplinary committees, market surveillance committees, and our experience has been generally good.

Mr. GLICKMAN. Thank you, Mr. Chairman.

Mr. JONES of Tennessee. Thank you, Dan.

Any other member of the subcommittee have a question?

[No response.]

Mr. JONES of Tennessee. If not, thank you very much, gentlemen, for the time that you have devoted to this issue, and we appreciate your interest.

Before I call up the next panel, if there's no objection, I'm going to ask the Chairman of the Commodity Futures Trading Commission, Susan Phillips, to come forward. I want to give her an opportunity to answer any of the charges that have been made against the Commission at this time by the panel.

Susan, several questions have been raised by the previous panel which I'd like for you to address since you were here to observe the testimony and since you so graciously consented to remain with us at the request of the subcommittee. What is your response to the complaint that the CFTC's contract approval time is unnecessarily lengthy compared with the SEC?

Ms. PHILLIPS. Thank you, Mr. Chairman.

With your permission, I'd like to submit some statistics for the record with respect to our approval time.

[The material follows:]

CONTRACT DESIGNATION APPROVALS

The CFTC has approved nineteen futures market designation applications and twenty-five option market designation applications filed between January 11, 1983, the effective date of the statutory one-year time limitation for Commission designation reviews, and March 24, 1986. (See attached Tables 1 and 2.) Three of the option market designations were based on physical commodities, including two (ACC gold bullion and PHBT Eurodollars) that also involved new exchanges. The other option on a physical commodity (CBT European Currency Unit) involved an existing exchange, and the remaining twenty-two option market designations were based on existing futures contracts.

Although all of these applications have been approved prior to or on the statutory review deadline, in several cases the total elapsed time between an application's submission and its approval has exceeded twelve months. This is because the amendment to Section 6 of the Commodity Exchange Act that imposes the one-year review limitation also includes a tolling provision. This provision authorizes the Commission to stay the running of the one-year review period in cases where it notifies a board of trade that its application is materially incomplete and specifies to the exchange the deficiencies in its application. In these cases the one-year review period is stayed from the time of such notification (which is communicated to an exchange in writing) until the application is resubmitted in complete form (that is, until all specified deficiencies are corrected). In addition, Section 6 of the Act has been interpreted to permit an exchange voluntarily to stay the running of the one-year clock under certain conditions.

With respect to certain complex designation applications, the Commission has been required to notify a board of trade of deficiencies more than once. This has occurred almost exclusively when an exchange's response fails to correct fully the deficiencies specified in the Commission's original notification. In other cases, less pervasive problems that have not required significant contract modifications or substantial additional exchange analysis have been communicated to an exchange informally by telephone, and the exchange has been given a specified period to reply without any interruption of the one-year review period.

Eleven of the nineteen futures market designation applications noted above have required at least one formal notification of deficiencies. Referring to Table 1, formal deficiency notifications were required in each of the six cases where the elapsed period from submission to approval (the "pending period") exceeded one year and in five cases where it did not. As a result, the average review period -- the pending period minus the tolling period -- was well under one year (7.0 months). It should be noted that the CSCE CPI-W contract tolling period includes a period of five months during which the one-year review period was stopped voluntarily by the CSCE with agreement by the Commission.

On the other hand, most of the problems that have arisen with respect to the Commission's review of option market designation applications have been handled without resorting to a formal tolling of the one-year time period, as shown in Table 2. This is primarily a result of the fact that most of these applications for options on futures have been based on long established, active futures contracts. Formal notification of deficiencies has been required for all three of the options on physicals applications, but for only two of the twenty-two applications for options on futures. As a result, the average pending period for option applications (7.2 months) exceeds only slightly the review period net of tolling (6.4 months).

Prior to the effective date of the one-year review period for contract designations, when a particular exchange had a large number of contract proposals pending CFTC consideration the Commission was able to accommodate the exchange's priorities by directing CFTC staff resources to those proposals the exchange was most interested in without regard to the filing dates of the proposals. Currently, the review period for such an exchange's low priority proposals would have to be formally stayed if the Commission staff were to follow the priorities established by an exchange for its pending contract proposals.

In practice, however, this required difference in procedures has been mitigated by two factors. First, shortly after the one-year designation review period became effective, the Commission imposed a $10,000 filing fee for futures and option market designation applications to be imposed on all new applications and previously submitted applications which were not withdrawn by the submitting exchange by a specified date following imposition of the fee. As a result, many low priority, previously submitted applications were withdrawn by the exchanges; however, some were not, e.g., certain futures contract proposals based on sector- or industry-based stock indexes. Second, exchanges have chosen not to respond to CFTC deficiency letters received on low priority contract proposals, or in special circumstances, have voluntarily stayed the running of the one-year clock as it applied to such proposals.

It should be noted that the option designation experience included the commencement of the Commission's agricultural options pilot program. Under this program, nine option designation applications (one application each from three exchanges and two applications each from three other exchanges) were filed almost simultaneously. However, the Commission reviewed them in two separate groups. Review of the first group, which included one application from each of the six filing exchanges, took approximately six and one-half months and the contracts were designated on October 29, 1984. Review of the second group, consisting of the second application from the three exchanges which filed two, was completed on January 29, 1985. Subsequently, a second agricultural option from one of the exchanges was designated approximately 5 months after submission to the Commission.

(Attachments follow:)

Table 1

Futures Designation Applications Submitted Since January 11, 1983, Which Have been Approved by the CFTC

Contract	Date Submitted	Date Designated	Pending Period 1/	Tolling Period 2/	Review Period 3/
			---------	months	------------
MCE Copper	01/11/83	10/10/84	21	13½	7½
MCE Soybean Meal	01/14/83	03/26/85	26½	14½	12
CME S&P 100	05/02/83	07/12/83	2	0	2
COMEX Aluminum	05/17/83	12/06/83	6½	1½	5
KCBT Mini VLA	05/23/83	07/26/83	2	0	2
MCE Platinum	05/24/83	07/17/84	14	5½	8½
CSCE CPI-W	06/23/83	04/16/85	22	10	12
CBT AMEX Market Value Index	10/21/83	06/19/84	8	0	8
CBT AMEX Major Market Index	10/21/83	06/19/84	8	0	8
CME Crude Oil	12/02/83	06/18/85	18½	8½	10
CBT Long Term Municipal Bonds	01/13/84	05/29/85	16½	6½	10

PHBT National Over-the Counter Index	12/04/84	09/11/85	9	0	9
NYCE U.S. Dollar Index	12/04/84	11/19/85	11	5	6
NYCE European Currency Unit	3/08/85	12/17/85	9	4	5
CME S&P OTC Industrial Stock Price Index	2/07/85	10/24/85	8	0	8
CBT NASDAQ-100 Index	2/14/85	10/24/85	8	0	8
CBT AMEX Maxi Major Market Index	03/26/85	08/01/85	4	0	4
CME European Currency Unit (physical)	4/18/85	1/14/86	9	5	4
CBT European Currency Unit	7/12/85	1/28/86	6	2	4
AVERAGE			11.00	4.00	7.00

1/ Elapsed time period from date of submission to date of designation.

2/ Time period during which submission was materially incomplete and/or during which statutory one-year review period was stayed voluntarily by submitting exchange.

3/ Pending period minus tolling period.

Table 2

Option Designation Applications Submitted Since January 11, 1983, Which Have Been Approved By the CFTC

Contract	Date Submitted	Date Approved	Pending Period 1/	Tolling Period 2/	Review Period 3/
			---------	months	------------
CME Deutschmark	2/18/83	12/13/83	10	0	10
ACC Gold Bullion	03/25/83	02/15/85	22½	12	10½
CBT Soybeans	03/15/84	10/29/84	7½	0	7½
COMEX Silver	03/19/84	08/21/84	5	1	4
NYCE Cotton	04/12/84	10/29/84	6½	0	6½
MGE Wheat	04/13/84	10/29/84	6½	0	6½
KCBT Wheat	04/16/84	10/29/84	6½	0	6½
MCE Wheat	04/17/84	10/29/84	6½	0	6½
CME Live Cattle	04/18/84	10/29/84	6½	0	6½
CME Live Hogs	04/18/84	01/29/85	9½	0	9½
MCE Soybeans	04/18/84	01/29/85	9½	0	9½
CBT Corn	04/18/84	01/29/85	9½	0	9½
PHBT Eurodollars	07/16/84	05/08/85	10	1	9

CBT Silver	08/27/84	02/12/85	5½	0	5½
CBT Long Term Treasury Notes	10/04/84	04/23/85	6½	0	6½
CME Swiss Francs	10/05/84	02/22/85	4½	0	4½
CME British Pounds	10/05/84	02/22/85	4½	0	4½
CME Euro-dollars	10/05/84	03/19/85	5½	0	5½
CSCE Cocoa	6/24/85	12/17/85	6	0	6
NYCE/CA Frozen Concentrated Orange juice	7/16/85	12/17/85	5	0	5
CBT European Currency Unit	7/26/85	3/04/86	7½	3	4½
CME Japanese Yen	12/09/85	3/04/86	3	0	3
CBT Municipal Bonds	12/16/85	3/21/86	3	0	3
CME Three-month T-Bills	12/09/85	3/21/86	3½	0	3½

Ms. PHILLIPS. By way of summary, I would like to give you a brief rundown on the contract approval experience since the reauthorization in 1982. As you will recall, in 1982 the Congress did put a 1-year time limit on the Commission's consideration of new contracts unless those contract applications were deficient or incomplete in some way. And since 1983, when that law went into effect, the average length of time that it has taken us to approve new contracts for futures has been 11 months. And if you take out the tolling period during which exchanges have been asked to either submit additional materials or complete their applications, the average length of time is 7 months. In the options area, the average length of time has been 7 months, and more recently we are down to 3 to 4 months for approval of new options contracts.

We've been approving, on average, about 20 per year since 1983, and we're up to about 30 this year. So the Commission believes that significant improvement has been made. But I would like to submit additional statistics for your consideration for the record.

Mr. JONES of Tennessee. We'd be glad that you do that.

You answered my second question in regard to the 1982 act about the time limits of your filing and reporting. I have one other question.

What is your response to the Chicago Mercantile Exchange's legislative proposal to invoke restraints on the Commission's rulemaking process?

Ms. PHILLIPS. I guess I'd certainly be very interested in seeing what their specific legislative proposal is. We have not seen that.

I would say, and I think as the committee is well aware, we, of course, operate under the strictures of the Administrative Procedures Act; and, of course, all rulemakings in which we engage are governed by those procedures. I would say that when we are considering engaging in a rulemaking, often there are conversations with various affected parties prior to putting out either an advance notice of proposed rulemaking, or a proposed rulemaking. But I would say that there are parties concerned with Commission rulemakings that go beyond just the industry. And in particular, it is a public rulemaking process, and we seek and invite the comments of all affected parties, including members of the public.

I do think that the capital rules probably are a good example of that kind of process. We put a rule out for comment for 60 days, and several members of the public submitted comments. In addition, we've had requests to extend that comment period several times—not just from representatives of the industry, but also affected parties. So it is a much broader procedure. Again, I'll be glad to take a look at any specific proposals that the CME has, but we, of course, are guided— and think we should be guided—by the Administrative Procedures Act.

Mr. JONES of Tennessee. Thank you very much.

Mr. Glickman, do you have a question?

Mr. GLICKMAN. I just want to echo what you said, and that is—I would be very suspect of an effort to try to modify the way this agency makes rules. I think that we ought to be consistent in the way rules are made throughout Government. And I think you also said something very important, you represent the public as well as private parties; and if you are required to prenegotiate and restrict yourself to an arbitrary, substantive rules standard, then you are not representing the public. And it is sometimes uncomfortable to represent the public, both on your side and the other side. I think you have to be reasonable, and I think that you have to be responsible in terms of understanding what the costs of your proposals are going to do to people. But I'm not going to be a party to a procedure that excludes the public from that initial part of the process, and I don't think you should be, either.

Ms. PHILLIPS. Thank you very much. We appreciate your support.

Mr. JONES of Tennessee. Thank you, Dan.

Tom, do you have any questions to ask Susan?

Mr. COLEMAN. I wonder if you might comment on Mr. Wilmouth's vehement opposition to you on your change in rules—being able to overrule, I guess, NFA's regulations.

Ms. PHILLIPS. Yes; I'd be glad to comment on that.

The Commission is, of course, making this recommendation, certainly recognizing the experience that we've had both with NFA and with other self-regulatory organizations over which we have responsibility. And I guess that, to me, is a key relationship. It is a question of oversight, and the Commission is seen to oversee NFA.

It is certainly true that we can write rules, and NFA would "have to conform" their rules to ours. But I think one of the important things in the formation of NFA was that the Commission would not be writing all of the rules, so that probably is a fairly inefficient way to proceed.

It leaves us in a very polar situation, however, with respect to approving their rules, or disapproving their rules. We either have to approve it or we have to disapprove it. Now, if we disapprove it and it's a rule that has some immediate significance—for example, capital rules—in that situation, there may be a regulatory gap. So it does leave a certain amount to be desired—with respect to regulatory coverage.

NFA, I think, has made great strides as a voluntary organization. I would note, though, that the Commission does require that its registrants belong to a self-regulatory organization; and for those CFTC registrants that are not exchange members, they must belong to NFA since that is the only self-regulatory body in existence. When we passed that rule, there were comments submitted to us—for example, by the Justice Department—and one of the responses to that is that we are the Federal agency that oversees NFA. We obviously feel that that would be a strong oversight tool for us. We receive very strong, very good cooperation from NFA. It is not a power that we anticipate to use regularly, lightly, and so on, but it is a question of oversight. And I think that some of the questions that Mr. Glickman was asking with respect to the NASD authority—excuse me, SEC's authority over NASD—are certainly pertinent because those do go to the same kinds of oversight rules with respect to capital financial responsibility and registration requirements. So there is a good deal of parallel there.

Mr. COLEMAN. Thank you.

Mr. JONES of Tennessee. Thank you, Tom.

Steve, do you have some questions?

Mr. GUNDERSON. Just one, Mr. Chairman.

Susan, I'd appreciate it if you could comment—Mr. Sandner made some rather strong statements about the rulemaking as it regards capital requirements for futures commission merchants.

Let me just read to you a sentence out of his testimony: "In doing so, the CFTC acted without a sufficient study, without sufficient calculations, without consultation or assistance from private sector experts."

Have you people overreacted? Do you have a study on the basis of the proposed regs? What are your comments in these areas?

Ms. PHILLIPS. As you may recall, the Volume Investors incident occurred in March, and the rules were promulgated—excuse me, not promulgated but originally proposed—in August. There was a formal study issued in July, so there was significant study.

I might also add that when we put the proposed capital rules out, we had a formula for the calculation of capital. We also asked what would be the effect if we changed the rule this way, if we excluded hedge accounts, if we excluded omnibus accounts, or if we made certain other kinds of calculations. So the question as to how firms are affected certainly would depend on how these various other aspects were considered.

I guess I'd have to disagree. I think that there was considerable study. I think the very fact that there was strong reaction from the industry is recognition that it's an important area, and I think that the very fact that the exchanges and FIA were not only willing, but initiated their own committees to develop alternate proposals, gives additional credence to the need to look to capital changes.

But certainly, we are willing to look at other proposals, and this is clearly still an open Commission rulemaking.

Mr. GUNDERSON. Thank you.

Thank you, Mr. Chairman.

Mr. JONES of Tennessee. Thank you very much, Steve.

Mr. Evans. Do you have some questions?

Mr. EVANS of Iowa. I have one, Mr. Chairman.

Susan, on the comments made on the handling of the trading tickets and the sequencing of them, are you generally in agreement that that is an acceptable manner of handling that element of the CTR?

Ms. PHILLIPS. Well, really, what has happened is that the exchange has described to us generally how they intend to go about doing it. They will have to submit the rules that would enable that; and I think, as is usually the case, when you start to put pen to paper in developing the rules, that a little more detail may come out.

So based on what we have heard, we think that that will be, certainly, an enhancement to our ability to detect certain kinds of abuses. But I guess I've said it before; the proof is going to be in the pudding. No. 1, will it work? And, of course, we'll wait to see the rules as they are submitted.

Mr. EVANS of Iowa. Is there an impasse at all, then, in getting the exchange to proceed with some of the long term commitments that it has to make, or not?

Ms. PHILLIPS. I think actually that's a question that perhaps should be put to the exchanges. We have encouraged them to go ahead and start developing this system, but I think you're exactly right; there is a time to start committing the money to doing this and moving forward.

Mr. EVANS of Iowa. And you certainly reserve the right to review and approve or disapprove some of the details of exactly how it's applied at a later date, is that what you're saying? You almost have to?

Ms. PHILLIPS. My sense is, basically, that I think that their concept is pretty well developed. But we would certainly expect that various of the details may be changing as they more fully flesh out the proposal.

Mr. EVANS of Iowa. Thank you.

Mr. JONES of Tennessee. Thank you very much, Mr. Evans.

Now, Susan, the floor is yours to defend anything that the panel might have said that you want to refute at this time.

Ms. PHILLIPS. Mr. Jones, might I say, first of all, that I had several things written down and you all have covered all of the topics that I wished to raise. But on behalf of the Commission I'd like to thank this subcommittee very much for their interest and their support of our programs.

Mr. JONES of Tennessee. On behalf of the subcommittee, we want to thank you for the job that you've done, too. Thank you very much.

Ms. PHILLIPS. Thank you very much, Mr. Chairman.

Mr. JONES of Tennessee. Panel No. 2, if you will come forward, please: Mr. Gary Seevers, vice president of Goldman, Sachs & Co.; Mr. Theodore Thomte, National Association of Futures Trading Advisors; Mr. James Layton, president, Clayton Brokerage Co., St. Louis; Mr. Lawrence Molner, senior vice president, Dean Witter-Reynolds, Chicago; and Mr. Thomas Russo, attorney for Cadwalader, Wickersham & Taft, New York.

We will follow the order in which the witnesses are listed on the agenda and Gary, you are first. Welcome back. We haven't seen you for a while, and we are glad to see you.

STATEMENT OF GARY L. SEEVERS, VICE PRESIDENT, GOLDMAN, SACHS & CO.

Mr. SEEVERS. Every 4 years, sir. Despite Mr. Damgard being kind enough to volunteer me to testify as an expert witness on off-exchange instruments, I'm actually here to testify on two other regulatory issues, and only two.

To put it in perspective, my responsibilities at Goldman, Sachs put me in the position of having overall duties, working with our institutional clients that are using futures markets for hedging, for risk management purposes, and occasionally, for speculative purposes. But we work with pension funds, mutual funds, and so forth who are actually using the futures markets. And I'm head of that area at Goldman, Sachs. And my two regulatory concerns both deal with institutional investors and obstacles to their using futures markets.

The first issue and the primary one that I will speak about is the serious need to revise and update the Commission's definition of hedging. The second issue that I want to identify is the need to exempt certain institutions from what I consider unnecessary regisright; there is a time to start committing the money to doing this and moving forward.

Mr. EVANS of Iowa. And you certainly reserve the right to review and approve or disapprove some of the details of exactly how it's applied at a later date, is that what you're saying? You almost have to?

Ms. PHILLIPS. My sense is, basically, that I think that their concept is pretty well developed. But we would certainly expect that various of the details may be changing as they more fully flesh out the proposal.

Mr. EVANS of Iowa. Thank you.

Mr. JONES of Tennessee. Thank you very much, Mr. Evans.

Now, Susan, the floor is yours to defend anything that the panel might have said that you want to refute at this time.

Ms. PHILLIPS. Mr. Jones, might I say, first of all, that I had several things written down and you all have covered all of the topics that I wished to raise. But on behalf of the Commission I'd like to thank this subcommittee very much for their interest and their support of our programs.

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Susan, I'd appreciate it if you could comment—Mr. Sandner made some rather strong statements about the rulemaking as it regards capital requirements for futures commission merchants.

Let me just read to you a sentence out of his testimony: "In doing so, the CFTC acted without a sufficient study, without sufficient calculations, without consultation or assistance from private sector experts."

Have you people overreacted? Do you have a study on the basis of the proposed regs? What are your comments in these areas?

Ms. PHILLIPS. As you may recall, the Volume Investors incident occurred in March, and the rules were promulgated—excuse me, not promulgated but originally proposed—in August. There was a formal study issued in July, so there was significant study.

I might also add that when we put the proposed capital rules out, we had a formula for the calculation of capital. We also asked what would be the effect if we changed the rule this way, if we excluded hedge accounts, if we excluded omnibus accounts, or if we made certain other kinds of calculations. So the question as to how firms are affected certainly would depend on how these various other aspects were considered.

I guess I'd have to disagree. I think that there was considerable study. I think the very fact that there was strong reaction from the industry is recognition that it's an important area, and I think that the very fact that the exchanges and FIA were not only willing, but initiated their own committees to develop alternate proposals, gives additional credence to the need to look to capital changes.

But certainly, we are willing to look at other proposals, and this is clearly still an open Commission rulemaking.

Mr. GUNDERSON. Thank you.

Thank you, Mr. Chairman.

Mr. JONES of Tennessee. Thank you very much, Steve.

Mr. Evans. Do you have some questions?

Mr. EVANS of Iowa. I have one, Mr. Chairman.

Susan, on the comments made on the handling of the trading tickets and the sequencing of them, are you generally in agreement that that is an acceptable manner of handling that element of the CTR?

Ms. PHILLIPS. Well, really, what has happened is that the exchange has described to us generally how they intend to go about doing it. They will have to submit the rules that would enable that; and I think, as is usually the case, when you start to put pen to paper in developing the rules, that a little more detail may come out.

So based on what we have heard, we think that that will be, certainly, an enhancement to our ability to detect certain kinds of abuses. But I guess I've said it before; the proof is going to be in the pudding. No. 1, will it work? And, of course, we'll wait to see the rules as they are submitted.

Mr. EVANS of Iowa. Is there an impasse at all, then, in getting the exchange to proceed with some of the long term commitments that it has to make, or not?

Ms. PHILLIPS. ~~I~~ think actually that's a question that perhaps should be put to the exchanges. We have encouraged them to go ahead and start developing this system, but I think you're exactly surance Co. will testify on behalf of several insurance companies about what form this relief should take.

Action in this area, the CT area, will remove obstacles to expanded uses of financial futures and options and will release the Commission's resources to focus on other areas without really creating any kind of regulatory gaps. Both these changes--CTA relief for institutional investors, and an improved definition of hedging for institutional investors—are really essential issues that should be addressed in order to make the full economic benefits of futures and options markets available to these institutions.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Seevers appears at the conclusion of the hearing.]

Mr. JONES of Tennessee. Thank you very much, Gary, for your statement and I assure you that the committee will take a good look at it before we proceed in the reauthorization process.

Our next witness is Mr. Theodore "Ted" Thomte. Mr. Thomte, we're glad you're here, and you may proceed.

STATEMENT OF THEODORE THOMTE, PRESIDENT, NATIONAL ASSOCIATION OF FUTURES TRADING ADVISORS

Mr. THOMTE. Thank you, sir.

My name is Ted Thomte. I am president of the National Association of Futures Trading Advisors.

In consideration of the hour, Mr. Chairman, I'll substantially abbreviate my remarks and submit the full remarks for the record.

Mr. JONES of Tennessee. I'm positive there'll be no objection to that, Mr. Thomte. [Laughter.]

Mr. THOMTE. NAFTA is a national trade association in the trading advisory area with approximately 175 commodity money management professionals who manage about $800 million in commodity investments for over 5,000 clients. Our members are active as commodity trading advisors and commodity pool operators; they operate or advise a substantial number of the pools and managed accounts currently in existence. Our segment of the futures industry is a relatively new and growing one.

We welcome the opportunity to report to the committee on our experience in operating under the current regulatory structure governing the futures industry. We wish to commend the efforts of the CFTC and the NFA in regulating the industry, including our own highly-specialized segment of this field. In our opinion, these agencies have demonstrated competence and professionalism in coordinating their regulatory programs to the benefit of both the public and the industry.

We are especially appreciative of the CFTC's action in designating a special counsel for regulatory matters affecting pool operators and trading advisors, an action which we believe is generally symbolic of the CFTC's recognition of the highly specialized nature of our field.

We are also pleased to report that the National Futures Association has met our expectations and the expectations of our membership regarding self-regulation. The development of NFA and its assumption of growing responsibility have, to a great extent, made regulation more efficient and more protective of the public interest.

Rather than going into a number of different areas where NFA has accomplished its tasks very well, I'll skip to the audit and education area where we believe NFA has done a particularly good job.

NAFTA is most interested in this area because it constitutes the primary mechanism for overseeing compliance of pool operators and trading advisors under both CFTC and NFA rules. Although this audit function could be performed with only a narrow focus on enforcement, NFA audits have concentrated on member education, as well. Many of NAFTA's members are relatively small pool operators or trading advisors. These members have been assisted by NFA staff in implementing changes in recordkeeping and reporting procedures and in modifying their disclosure documents to conform with applicable CFTC and NFA requirements.

NAFTA believes that an essential element of industry self-regulation is education of the members as to their regulatory and compliance responsibilities because a large percentage of technical violations arise from incomplete understanding of applicable rules. As a membership organization, NFA serves its members and the public well by counselling its members on matters related to regulation and compliance. We believe that a good start has been made in that area and should be built upon and expanded.

NAFTA specifically wishes to acknowledge the assistance received by NAFTA members from NFA staff in developing and improving their compliance procedures.

I'd like to comment on a couple of specific issues that have been raised during the course of these hearings.

We support the CFTC's proposal to extend the period between congressional reauthorizations of the agency to 6 years from the present 4. We believe a 6-year reauthorization period would contribute to regulatory efficiency by conserving the resources of the CFTC, the industry, and the Congress.

Gary Seevers has recommended that the CFTC's definition of bona fide hedging transactions be modernized to bring it in line with prudent trading strategies now employed by many investment managers in connection with financial futures transactions. We fully support this recommendation, and we are hopeful that commodity money managers will be accorded the same regulatory treatment that investment advisors who hedge client portfolios are accorded.

Thank you for your attention, and I'd be happy to elaborate on any of these matters, either with members of the committee or the staff.

[The prepared statement of Mr. Thomte appears at the conclusion of the hearing.]

Mr. JONES of Tennessee. Thank you very much, Mr. Thomte, and when we have finished we'll give the members an opportunity to ask questions.

The next witness is Mr. James Layton, president of Clayton Brokerage Co., St. Louis.

STATEMENT OF JAMES A. LAYTON, PRESIDENT, CLAYTON BROKERAGE CO.

Mr. LAYTON. Thank you, Mr. Chairman and members of the subcommittee. My name is James A. Layton; I'm president of Clayton Brokerage Co. of St. Louis, a full-service futures commission merchant located in St. Louis, MO, with 27 branch offices, a substantial home office with research and clearing capabilities, and exclusive support and clearing affiliations with over 150 independent introducing brokers. We have been in the commodity futures business since the early 1950's.

We are pleased to have this opportunity to offer the views of our firm in connection with your consideration of legislation to reauthorized the Commodity Futures Trading Commission.

I'd first like to address my remarks to agricultural options. Clayton Brokerage joins others in the commodity and agribusiness industries to urge Congress to end the pilot program. In our judgment, ag options have been extremely successful and it is time to open the program in order to offer additional products to market users. Despite generally depressed agricultural markets, trading in these options has exceeded the initial performance of nonagricultural options.

Clayton Brokerage clients have found agricultural options to be a useful tool in marketing farm and ranch productions. Economists and academicians have thoroughly documented the theoretical advantages commodity options provide producers in stabilizing and enhancing their incomes. I am here today, however, to show you some real life examples of how our farmer/rancher clients have benefited from the availability of commodity options.

While we have found all options to be useful to individual customers, our experience suggests that cattle options have been the most popular with agricultural hedgers. Cattle options have found ready acceptance throughout the cattle industry at large. On February 18, 1½ years after introduction, open interest in cattle options totalled 30,000 contracts. It took more than 4 years for cattle futures to attain the same level of participation.

Recently, the number of cattle options traded has averaged 23 percent of futures volume, still below—but rapidly approaching—the 41 percent for Treasury bonds, by far the largest options market in the world. Over the past year, cattle options volume has grown 680 percent against a 350 percent growth rate for T-bonds. The cattle options market has clearly been a success.

Since the commencement of cattle options trading on October 30, 1984, cash cattle prices at Omaha have varied from $53.35 to $66.50 per hundredweight. Feeding margins—the value of live cattle minus feed and feeder steer costs—averaged $5 per hundredweight. Just 1 month's variation in price could nearly wipe out the feeder's profit margin, and corn belt feeders typically hold cattle for 6 to 8 months.

Our clients have found Put options a convenient means of insuring against price decline, and yet still benefiting if prices move sharply higher. Futures markets provide a means of hedging against downward price movement, but they don't allow the feeders to profit when prices move up.

Farmer feeders are optimistic by nature, but their bankers don't always have that optimism and enthusiasm for it. Many banks now require that farmer feeders hedge their operations, providing additional security to production loans. Options provide an excellent means for farmers to secure their loans and still indulge their optimism.

Some producers also enjoy not having to worry over margin calls when futures prices are moving against their futures positions. Small producers, especially, lack the facilities or financing for maintaining margin money in fast-moving markets. With options, these producers can make deposits to cover the premium cost of a Put and not be concerned with providing additional margin money when prices decline.

Our exhibit A provides a chronology of one Texas cattle feeder's use of cattle options to hedge against the risk of declining cattle prices. The rancher, who had 225 cattle on feed in early December, when cash cattle were trading at $66 per hundredweight, purchased six February cattle Put options at that time. The feeder liquidated these options at expiration in late January, accepting a short futures position. In early February, he sold his cattle for $57 per hundredweight and liquidated the futures position. The farmer calculated his cost of production at $61 per hundredweight, which would have resulted in a $4 per hundredweight—or a nearly $10,000—loss on his 225 head of cattle. The Put options transaction netted the farmer $5.55 per hundredweight profit, or more than $13,400. In summary, the farmer netted approximately $3,400 from his feeding operation with options against a $10,000 loss without options.

This is just one small example of a farmer who has benefited from options trading. We have included several other examples for your examination. Of course, if cattle prices rise, losses in options will deduct from the farmer's production income. The point is, options are providing protection in uncertain markets, and farmers are taking advantage of this valuable tool.

Next I would like to comment briefly on the proposed changes to the CFTC capital rule to reshape the futures business by changing the way firms do business in light of the recent bankruptcy of Volume Investors.

We recognize the need for firms to have adequate safeguards; however, in the interests of a competitive society, we feel it is imperative that rules not be made so restrictive that they force many firms out of business and leave the industry in the hands of a few very large corporations.

Last, regarding the 1-minute trade execution recording rule, we have never had a customer complaint that related to the audit trail problem involved in the new proposed CFTC regulation. While we do not believe there is evidence of frequent widespread market abuse, like others in the industry, we recognize that there must be a system to detect such abuses if and when they occur. However, this system must be a practical one. It should not be so sophisticated, so cumbersome, and so complicated that it interferes with the workings of the greatest free market system in the world.

Thank you, Mr. Chairman, for the opportunity to appear before your subcommittee. I respectfully urge you to accept the proposal which you have received to lift the pilot program restrictions on the development of additional agricultural commodity options. They are proven, effective hedging vehicles for producers who, as you well know, can use all the marketing help they can get.

I will be pleased to answer any questions.

[The exhibit follows:]

EXHIBIT A

Here is a very basic example of how one of our customers used cattle options.

APRIL 9, 1985
SITUATION: CUSTOMER CALLED -- WANTED DOWNSIDE PROTECTION
CATTLE WERE ALREADY ON FEED
PROJECTED OUT DATE -- MID-JUNE 1985
# OF HEAD ON FEED -- 372
PROJECTED OUT WEIGHT -- 1,075 (STEERS)
# OF CONTRACTS NEEDED -- 372 x 1,075 / 40,000 = 10

ACTION: ELECTED TO BUY 10 JUNE 64 CATTLE PUTS FOR .60
.60 x 40,000 x 10 = $2,400.00 + 601.60 (COMMISSION .10 x $60.16)
TOTAL OPTION COST $3,001.60
ESTIMATED BREAKEVEN BEFORE PUTS 65.00
COST OF PUTS .75 (.60 + .15 COMMISSION)
NEW BREAKEVEN 65.75
PUT FLOOR 64.00
RISK EXPOSURE ASSUMING EVEN BASIS 1.75 (65.75 - 64.00) PER CWT.
POTENTIAL PROFIT UNLIMITED (TOTAL GAIN - PREM PAID FOR OPTION)

MAY 24, 1985
OPTIONS ARE DUE TO EXPIRE
JUNE FUTURES ARE TRADING AT 63.57
WE ELECT TO EXERCISE OPTIONS AT 64.00

JUNE 5, 1985
CATTLE ARE SOLD FOR 59.50
BUY BACK FEB FUTURES AT 59.72

ASSUMING NO PRICE PROTECTION HAD BEEN TAKEN
ESTIMATED BREAKEVEN 65.00
SELLING PRICE 59.50
LOSS 5.50 CWT. OR $21,999.45 (5.50 x 1,075 x 372)
59.12 PER HEAD LOSS

WITH PUT PROTECTION/EXERCISED INTO FUTURES
ESTIMATED BREAKEVEN 65.75
SELLING PRICE 59.50
LOSS 6.25 CWT.

OPTION EXERCISED 64.00
BOUGHT FEB AT 59.725
PROFIT 4.275 CWT.

NET LOSS 4.275 - 6.25 = 1.975
TOTAL 1.975 x 1,075 = $21.23 PER HEAD x 372 = $7,898.02
FUTURES COMM. 601.50
NET LOSS 8,499.62

IN SUMMARY IF CUSTOMER HAD NOT USED OPTIONS HIS CATTLE WOULD HAVE LOST $59.12 PER HEAD AND WITH THE OPTIONS HE LOST $22.84 PER HEAD. THE BEST THING IS THAT IF THE MARKET HAD GONE UP HE COULD HAVE PARTICIPATED IN THE MOVE.

EARLY JULY 1985
SITUATION: YEARLING STEERS HAVE BEEN PURCHASED AND WILL FINISH IN LATE NOVEMBER

# OF HEAD 186
PROJECTED WT 1,075
OF CONTRACTS NEEDED 186 x 1,075 / 40,000 = 5

ESTIMATED BREAKEVEN	60.00
CURRENT CASH MKT	58.00
DECEMBER FUTURES	62.00

DECEMBER PUT OPTIONS:

STRIKE	PREMIUM
62	2.25
60	1.50
58	.80
56	.40

THE FEEDER WAS UNCERTAIN ABOUT MARKET DIRECTION SO HE PURCHASES A 80 PUT ONLY $2.00 OUT OF THE MONEY

ESTIMATED BREAKEVEN	$60.00
PUT COST (1.50 + .15 COMM)	1.65
NEW BREAKEVEN	$61.65
FLOOR (PUT)	60.00
RISK EXPOSURE	$ 1.50 CWT.

ON NOVEMBER 22 THE CATTLE WERE SOLD FOR 65 AT THAT TIME THE DECEMBER FUTURES WERE AT 66.90, SO THE PUTS BELOW THAT PRICE WERE NO VALUE

STRIKE	PREMIUM
60	-0-
58	-0-
60	-0-

HAD THE CUSTOMER HEDGED INSTEAD OF USING PUTS HIS UPSIDE POTENTIAL WOULD HAVE BEEN ELIMINATED AND THE RESULTS WOULD HAVE BEEN

ESTIMATED BREAKEVEN	60
SOLD DEC. FUTURES	62
NOVEMBER 22	
SOLD CATTLE	65
BREAKEVEN	60
FEEDING GAIN	5.00
SOLD DEC. FUTURES	62.00
BOT DEC. FUTURES	66.90
	4.90

NET GAIN ON CATTLE IF HE HAD HEDGED
5.00 - 4.90 = .10 CWT.
.10 x 1,075 LBS x 186 PD = $199.95

BY USING THE PUTS HE PROTECTED HIS DOWNSIDE AND LEFT THE UPSIDE OPEN AND THE RESULTS WERE

NOV 22
SOLD CATTLE 65.00
BREAKEVEN (WITH PUTS) 61.65

NET FEEDING GAIN 3.35 CWT.
3.35 x 1,075 x 195 = $6,698.32

IN SUMMARY THIS CUSTOMER THROUGH THE USE OF THE OPTIONS LIMITED HIS DOWNSIDE RISK, LEAVING THE UPSIDE OPEN. THE END RESULT WAS A PROFIT OF $6,698.32. IF THE CUSTOMER HAD NOT HAD THE CHOICE OF OPTIONS AND ELECTED TO USE THE FUTURES MARKET, HE WOULD HAVE ONLY MADE $199.95.

HERE IS A VERY BASIC EXAMPLE OF HOW ONE OF OUR CUSTOMERS USED CATTLE OPTIONS.

DECEMBER 2, 1985
SITUATION: CUSTOMER CALLED -- WANTED DOWNSIDE PROTECTION
CATTLE WERE ALREADY ON FEED
PROJECTED OUT DATE -- MID FEB. 1986
OF HEAD ON FEED -- 225
PROJECTED OUT WEIGHT -- 1,075 (STEERS)
OF CONTRACTS NEEDED -- 225 x 1,075 / 40,000 = 6

ACTION: ELECTED TO BUY 6 FEB. 64 CATTLE PUTS FOR 160
1.60 x 40,000 x 6 = $3,842.00 + $380.96 (COMMISSION 6 x 60.16)
TOTAL OPTION COST $4,200.96
ESTIMATED BREAKEVEN BEFORE PUTS 61.00
COST OF PUTS 1.75 (1.60 + .15 COMMISSION)
NEW BREAKEVEN 62.75
PUT FLOOR 64.00
RISK EXPOSURE NONE ASSUMING EVEN BASIS
POTENTIAL PROFIT UNLIMITED

JAN. 22, 1986
OPTIONS ARE DUE TO EXPIRE
FEB. FUTURES ARE TRADING AT 58.75
WE ELECT TO EXERCISE OPTIONS AT 64.00

FEB. 11, 1986
CATTLE ARE SOLD FOR 57.00
BUY BACK FEB. FUTURES AT 56.70

ASSUMING NO PRICE PROTECTION HAD BEEN TAKEN
ESTIMATED BREAKEVEN 61.00
SELLING PRICE 57.00
LOSS 4.00 CWT. OR $9,675.00 (4.00 x 1,075 x 225)
43.00 PER HEAD LOSS

WITH PUT PROTECTION/EXERCISED INTO FUTURES
ESTIMATED BREAKEVEN 62.75
SELLING PRICE 57.00
LOSS 5.75 CWT.

OPTION EXERCISED 64.00
BOUGHT FEB. AT 56.70
PROFIT 7.30 CWT.

NET PROFIT 7.30 - 5.75 = 1.55
TOTAL 1.55 x 1,075 = $16.66 PER HEAD x 225 = $3,748.50
FUTURES COMM. 360.00
NET PROFIT 3,388.50

IN SUMMARY IF CUSTOMER HAD NOT USED OPTIONS HIS CATTLE WOULD HAVE LOST $43.00 PER HEAD AND WITH THE OPTIONS HE MADE $15.06 PER HEAD. THE BEST THING IS THAT IF THE MARKET HAD GONE UP HE COULD HAVE PARTICIPATED IN THE MOVE.

Mr. JONES of Tennessee. Thank you very much, Mr. Layton. We do appreciate your comments and your statement.

Our next witness is Mr. Thomas Russo, attorney for Cadwalader, Wickersham & Taft, New York.

STATEMENT OF THOMAS A. RUSSO, ATTORNEY, CADWALADER, WICKERSHAM & TAFT

Mr. RUSSO. Thank you, Mr. Chairman. I ask that my full statement be put in the record—unless, of course, you'd like me to read it.

Mr. JONES of Tennessee. Without objection. We'll leave it up to you; you do as you please because we'll stay here as long as you can. [Laughter.]

Mr. RUSSO. OK. I'll try to make it short.

Mr. Chairman and members of the subcommittee, I appreciate this opportunity to testify before you.

I am here today to express the concerns of many of my clients about certain speculative position limit issues.

There are those who contend that the fundamental problem with limits is that they exist at all. I do not intend to make this my major theme today; rather, I believe it is more productive to focus on three specific position limit-related problems.

First, many of the position limits that are currently in effect today are far too low.

Second, as Gary Seevers has already testified to, the CFTC's bona fide hedging definition which is used to exempt hedging positions from the limit requirements is also outdated.

And third, the CFTC's aggregation policy, which determines which positions must be added together for purposes of determining the size of a trader's speculative positions, is also outdated.

I believe that position limits are currently too small, and others have testified to this effect, including the Chicago Mercantile Exchange, the FIA, and other industry representatives. However, certain additional facts may be helpful to drive home this point. For example, limits on wheat and corn were set at 2 million bushels in 1938, and have been increased by only 1 million bushels since that time. Equally significant, the position limits on many financial futures contracts are much too conservative. For example, the position limits on the Chicago Mercantile Exchange's S&P 500 Index futures contracts—a very liquid, cash-settled contract—is only 5,000 contracts, net, long or short, in all contract months combined. At current levels, the S&P index—the cash value of these 5,000 futures contracts is approximately $600 million, which may appear substantial; however, these numbers become unimpressive when one realizes that a number of institutional money managers have $20 billion or more under management.

With respect to hedging, I will make my comments very brief since Gary Seevers has already spent time on that issue. The hedging definition has not been changed by the CFTC since 1977, even though many changes have occurred in the market since that period. In 1977, for example, only a limited number of financial futures were traded and trading volume in those instruments amounted to only 1.4 million contracts, or 3 percent of total futures volume. In 1985, on the other hand, a wide array of financial futures were traded and trading volume in those instruments amounted to 60 percent of total volume. Indeed, trading volume in Treasury bond futures alone topped 40 million contracts in 1985, making that contract the most actively traded financial futures contract on any exchange, with futures on the S&P index and the Eurodollar, respectively, capturing second and third place.

The CFTC should therefore be asked to reexamine this area and make its hedging definition more compatible with the needs and objectives of the large institutional users. If this is not done, those users will look elsewhere to satisfy their risk management needs, and the full economic potential of the financial futures and options markets will never be realized.

Finally, I wish to address the CFTC's aggregation policy. As noted previously, those policies govern the manner in which positions are added together for speculative limit purposes. Aggregating positions that are controlled by the same person may make some sense because a person who controls trading for an account may have the potential to manipulate market prices, at least in the case of some commodities. However, when positions are owned by an entity but controlled by someone else—that is, controlled by various trading advisers—it makes little sense to aggregate those positions because the owners of those positions have no ability to manipulate the market. Nevertheless, the CFTC currently aggregates positions on the basis of ownership as well as control.

As participation in the futures markets through various pooled investment vehicles has become commonplace, this emphasis on ownership—even in the absence of control—is becoming increasingly onerous. For example, a pension fund advisor who wishes to assume a long position in a particular commodity may find he is unable to do so because another advisor retained by that fund has independently determined to acquire a long position in the same commodity. In my view, this is bad economics because it prevents a money manager from fully implementing their desired investment and portfolio management policies, undercuts the advantages of employing more than one such manager, and makes the commodities markets a less attractive investment forum in which to operate. Moreover, it is bad regulatory policy. When traders operate independently of one another, their positions should be subject to separate limits, even if those positions are nominally owned by the same entity.

I would also go a step further to say that control should mean actual, not merely nominal, control. For example, the positions of two traders employed by the same firm should not be aggregated if those traders are not operating in tandem. The CFTC has already adopted this approach with respect to certain accounts managed by futures commission merchants, and should be encouraged to extend the logic of that approach to other types of market participants such as investment portfolio managers.

Finally, in my written testimony I deal with another important issue; I'll just touch on it briefly in this oral presentation. It's an issue that Gary Seevers also addressed, and that is whether certain institutions that are predominantly investment managers should be required to register as commodity trading advisors. The CFTC has recently exempted certain entities, such as insurance companies and mutual funds, from the commodity pool operator definition because those entities are already adequately regulated and should apply the same type of philosophy to certain otherwise regulated commodity trading advisors.

In the brief span of a decade, the futures exchanges have been transformed from markets that primarily serve the agriculturally related businesses to markets that serve the full gamut of our economic community. As this remarkable transformation has occurred, new types of participants with new types of needs, goals, and trading strategies have entered the markets and traditional ways of regulating those markets have become outmoded. I, therefore, believe that Congress should not forego this opportunity to facilitate position limits, aggregation policies, and hedging changes that will make the commodities markets more useful during the decade to come, and help to ensure the long-term viability and health of those markets.

If there is one thing that we can all agree upon, it is that the futures and options markets of the 1980's and 1990's cannot be well regulated with a 1930's mindset.

Thank you very much.

[The prepared statement of Mr. Russo appears at the conclusion of the hearing.]

Mr. JONES of Tennessee. Thank you very much, Mr. Russo, for your statement. That concludes the statement by the panel.

Mr. Evans, do you have any questions?

Mr. EVANS of Iowa. I have a question or two, or at least a comment or two, but I'll try to be very, very brief.

I would say to Mr. Layton that I am the member of the subcommittee that proposed pilot ag options 4 years ago, and I'm very much interested in your remarks and I can assure you that we'll give very serious consideration, at least, to broadening that out. I agree with you very much on your comments.

I'm curious to know if you see a danger of options completely replacing futures with a lot of your customers. And if one carries this to its logical conclusion and you have all options and no futures market, then where are you going to go? Do you have any comments on that?

Mr. LAYTON. Well, we feel that there will be a good blend of the two, and I know that some of my friendly competitors here were sort of chuckling about the size of the cattle options program going, but I think we all must realize—and that's the same way with the grains, with the options—there really has not been a lot of cash grain trading. And so once the channels start back in with where there is grain in the marketplace, I think the grain options will be utilized. And we do think that there will be a balance there, that there will not be that fear that some have expressed.

Mr. EVANS of Iowa. I would just make this other comment on the matter of limits. You can't imagine how unpopular your proposal will be with a lot of people in the country, I think; I mean, it's the total comment of farmers at this point that pools and large movements in and out of those markets are devastating to that small producer. I recognize what you're saying, and I recognize the need of some of the very large institutions and so on, but I think that's a question that needs to be examined from both ends and I don't have the answer to it. But I think that some of your larger operations can be devastating to some of the small operators, and that's got to be considered, too. And if you have any thoughts on how those two might be addressed in a compatible manner, I think we would like very much to have those suggestions. Perhaps we don't have time to do that very much today, but any brief comments along that line would be very useful to me.

Mr. RUSSO. I think you're 100 percent right. There are different considerations for the financial futures and for the agricultural futures, and maybe they should be dealt with in that regard—16 agricultural futures position limits are governed by the CFTC; all other futures position limits are subject to exchange rules approved by the CFTC. I think that, in and of itself, says that there are some differences, but I think the important part of my testimony is that ag position limits must be looked at because they seem to be small, but two, and maybe more significant, is with respect to the financial futures where you really don't have a lot of the same delivery problems and other issues. Consideration should be given to having position limits which deal with the realities and the size of the markets that they were meant to serve.

Mr. EVANS of Iowa. I know very little about the financial futures market, but I have the strong intuitive feeling that there probably are some small operators in that, too.

Mr. RUSSO. Well, it's probably hard to manipulate the T-bond market, although you never know, I guess——

Mr. EVANS of Iowa. Well, I think we need to look at that, and I don't have any good ideas; but if anybody does get some as to how you can protect both ends of the scale, I think it's a serious problem.

Mr. JONES of Tennessee. Thank you very much, Mr. Evans.

Mr. Coleman, do you have questions?

Mr. COLEMAN. Well, I have a clarifying question for Mr. Layton. As an FCM and in view of the Volume Investors issue that happened up there, and you refer in your testimony about the confidence factor, I was just wondering, what capital requirements are there on you now? It varies from exchange to exchange.

Mr. LAYTON. Right.

Mr. COLEMAN. What are those? Are they identical?

Mr. LAYTON. No; they would be—but I think the proposal, and I don't have the exact specifics, but it would work a hardship on a firm for the way that he would be maintaining positions and how those positions—as to what type, whether they be hedge positions or whether they would be for customers like the public. So the whole review of what is being asked, I think that you will hear from some of the exchanges that would indicate that about a third of members operating on the exchanges would be forced out of business. This is the concern that we have, is that we think that there is a happy medium here but that you do need to maintain people in the marketplace. And a review will indicate, as has been indicated here by the Chicago Merc and everything, that the regulatory bodies by the exchanges has been very successful in being sure that—in the one event that it did happen, it was taken care of in 1 day's time at the Chicago Board of Trade, for example.

So the things are in place, and to go into a very heavy, restrictive thing, as this looks like it would be, to cut out member firms, that's the concern we have.

Mr. **Coleman**. But you don't question the need for, as you say, adequate safeguards?

Mr. **Layton**. Not at all.

Mr. **Coleman**. Do you feel that there are adequate safeguards now without these additional requirements?

Mr. **Layton**. Yes; that was our point, that there are in effect, and there are in place now, safeguards that have been very, very workable through the period. And it has not been so that it has forced people out of business.

Mr. **Coleman**. But we're encouraging these ag options, and I just wonder—I think this committee would be very sensitive to a problem that would develop over forcing these, for example, cattlemen out into the options market because their banker requires it, and then have something happen like happened in whatever market it was in COMEX——

Mr. **Layton**. Well, I can assure you that when there appears to be any position or there appears to be any kind of market movement that would be of a sensitive nature, the framework wheels into gear and we get all kinds of calls as to the positions, who they are, how we view them, and everything—the system is really working in that regard. So I don't think you have to have any fear for that, Congressman; that system is in place, the people are very diligently working it, and they're putting it into a computerized-type system that can feed information and exchange information with the appropriate people. So that is really in place.

Mr. **Coleman**. OK. Thank you.

Mr. **Jones** of Tennessee. Thank you very much, Tom.

Mr. Glickman.

Mr. **Glickman**. Thank you, Mr. Chairman.

Just a couple of quick questions. Mr. Russo, your statement on position limits, as well as the hedging definition, you indicate that the Commission needs a little congressional encouragement. Are both of those problems remedied by statute or are they problems that can be remedied by rulemaking?

Mr. **Russo**. You picked the two that could be remedied by rulemaking, and my suggestion in the fuller testimony is that the committee report reflect the sentiments that were heard by various institutions and other witnesses, that something should be done in this area.

It is the third area—and I have some specific legislation——

Mr. **Glickman**. Is that the aggregation?

Mr. **Russo**. That is the aggregation. In footnote 12 of my prepared text I have a specific suggestion into certain things that might have to be changed in section 4(A)(1), and that would require—if the Commission is going to do anything—it would require a change in the statutes.

Mr. **Glickman**. OK. Well, I've asked Susan to comment on those suggestions.

I wonder, No. 2, if any of you could comment on the whole issue of off-exchange instruments? Not so much leverage, per se, but off-exchange, and as to whether you think the current regulatory and statutory framework gives the Commission all the authorities it needs to deal with the perhaps rapidly burgeoning number of instruments—currency swaps, interest rate swaps—whatever else may be coming down the pike.

Mr. SEEVERS. Yes; I'd be happy to comment on that.

I really think that the Commission should—the statute should not be changed with respect to off-exchange instruments in this reauthorization. I feel quite strongly about that. Just trying to limit some of the—or list some of the off-exchange instruments—options on debt, big, big market; options on foreign exchange, big, big market; I'll leave out the interbank forward market altogether because I don't think that's at issue; options on money market rates; interest rate swaps; forward rate agreements; caps that are separated from securities that are issued, then you get into EFP's and dealer options and leverage, topics we're all more familiar with—I think, in a sense, this off-exchange issue has been studied to death, and many articles have been written about it. Many meetings have been held.

I would say that there's no one who has been in this room today who is really informed enough or smart enough to say if the CFTC should have more authority or less authority in the off-exchange area. I think to step forward with any kind of legislation would be potentially pretty risky because I just don't think that people are capable——

Mr. GLICKMAN. You say it's been studied to death, and nobody knows enough about it?

Mr. SEEVERS. Yes; because the off-exchange issue—I mean, you're dealing with commercial instruments here. For example, we've done some off-exchange bond futures, if you want to call them that. We have sold forward for 60 days or 90 days, provided a forward rate on $300 million, $400 million. Those size trades are to major corporations. How often do we do that? I mean, we do thousands of futures trades for clients every day. We may have done, in the last year, six trades of that type. So that's one category of what people might want to call "off-exchange bond futures." To me, it's not even close.

But I think that you're dealing with commercial reality here; and to say that the Commission should be given more authority—or less, really—to intervene in that complicated area where you're dealing mostly with sophisticated entities, dealing among themselves, is something I would recommend against. My recommendation would be to do nothing in the off-exchange area, at least among the institutional kind of off-exchange instruments that are evolving and developing in this reauthorization.

Mr. GLICKMAN. Does anybody have any contrary remarks to what Mr. Seevers said on that issue?

[No response.]

Mr. GLICKMAN. OK. Let me just ask one final question. Perhaps Mr. Seevers or Mr. Russo may want to comment, but the other gentlemen as well.

As a lay person watching the securities markets lately, there's no question we've had an incredible amount of volatility. Mostly it's been generally upward volatility. And there have been some stories in the New York Times about the relationship between the options market and that short term volatility in the securities markets.

I wonder if any of you might want to comment on that, as to whether that is an accurate characterization. I'm just curious.

Mr. **Seevers**. Whenever any market moves in a significant way, people start looking at reasons for that sharp move. And I think it has been very convenient in the press to just list the "basket trades" or the futures or the options as the causes of some sizable moves in the market. So I think to take a sample reading of newspapers and to say that that's a reason to believe that futures are causing more volatility is simply not valid.

There may be occasions when these large cash futures, arbitrage programs, have triggered a big move in the market that might have come a little bit later on, so I'm not saying there has never been any effect in the "third Friday phenomenon" which we're going to have again in three more days—it's a phenomenon that's very closely watched, and in general, any aberrations associated with that third Friday have been diminishing over the course of the last two or three years.

I think on the other side, there are a lot of pluses. The S&P futures, for example, or New York Stock Exchange index futures, as well as the options traded on securities exchanges—those are big, liquid, important markets. And I believe in terms of overall stability and the ability for institutions that are doing very massive trades to get those trades done at a more efficient transactions cost, that the futures and options markets have added a great deal.

Mr. **Glickman**. Finally—this may be an unfair question, but given the fact that I'm asking the questions here, I would wonder—perhaps particularly, Gary—how do you characterize the way the CFTC has performed its responsibilities in the last year or two?

Mr. **Seevers**. You really know how to put a guy on the spot, I must say.

Mr. **Glickman**. You know, people ask me to characterize my colleagues, and you used to be in this spot. So I think it's a fair question.

Mr. **Coleman**. What about us?

Mr. **Glickman**. I say only good things about you, Mr. Coleman. [Laughter.]

Mr. **Seevers**. On that note, may I conclude? [Laughter.]

Well, I think the Commission has grabbed ahold, rightly or wrongly, of the toughest issue that it's faced since, really, day one. It used to be called 1-minute time stamping; now it has a somewhat more elegant name. And I think real progress is being made on that issue, and maybe that's the most important thing to say without pointing fingers about who has performed well or not performed well.

What I see is real progress in terms of moving toward the long run goal that everybody wants of being able to cost-effectively reconstruct the sequence of trading.

If you set that aside—and I think there have been quite a few contentious issues and tough issues; the capital rules have been changed, really, a number of times in fundamental ways over the years, and maybe some further change is in order. So rather than meandering on, I would say I would give them a B-plus and stop at that.

Mr. GLICKMAN. Thank you, Mr. Chairman.

Mr. JONES of Tennessee. Thank you, Dan.

That seems to conclude the question and answer session.

Because of the difficulty that we've had today in having subcommittee members here—and this has been a difficult day to have a hearing—I would like to ask unanimous consent that all members, after they have read and taken a look at the testimony, be given permission to submit any questions to any witnesses that we've had here today, for reply, if there's no objection to that.

Thank you very much, gentlemen, and ladies, for being here today. We appreciate it very much.

The subcommittee will stand in recess until 10 a.m. tomorrow.

[Whereupon, at 5:30 p.m., the subcommittee recessed, to reconvene at 10 a.m. Wednesday, March 19, 1986.]

[Material submitted for inclusion in the record follows:]

STATEMENT

OF

SUSAN M. PHILLIPS, CHAIRMAN

COMMODITY FUTURES TRADING COMMISSION

BEFORE THE

SUBCOMMITTEE ON CONSERVATION, CREDIT, AND RURAL DEVELOPMENT

UNITED STATES HOUSE OF REPRESENTATIVES

MARCH 18, 1986

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I am pleased to come before the Subcommittee today representing the Commodity Futures Trading Commission to update you on developments at the Commission since its Congressional reauthorization in 1982 and to present our legislative proposals for the 1986 reauthorization. While the Commission's reauthorization in 1978 and 1982 involved major revisions to the Commodity Exchange Act, the Commission does not believe that such extensive revisions are necessary at this time. Our legislative request is short, and it includes a request that the Commission be reauthorized for six years.

Before discussing our brief legislative requests, let me take a moment to report on our experience with the 1982 amendments to the Act.

I. CFTC Experience With 1982 Amendments

A. One-Year Statutory Review Limitation on Contract Market Designations

The Commission has successfully been able to meet both the letter and intent of the 1982 amendment to Section 6 of the Act which requires the Commission to complete action on contract market designations within one year from the time they are submitted to us. The amendment allows the Commission to stay the running of the one-year period upon notice to an exchange that its application is deficient. Implementation of this amendment has required the Commission and the exchanges to change some of their operating procedures, resulting in a somewhat more formal interchange. Nevertheless, the experience under these procedures has been generally positive.

Since January 11, 1983, the effective date of the statutory one-year review period, the Commission has timely designated contract markets for 32 futures and 21 options. Two of the options approved were based on physical commodities (American Commodity Corporation gold bullion and Philadelphia Board of Trade Eurodollars) and involved new exchanges, while the remaining 19 were based on existing futures contracts.

On certain complex designation applications the Commission has found it necessary to notify a board of trade of deficiencies more than once. This occurred almost exclusively when an exchange's response failed to correct fully the deficiencies specified in the Commission's original notice. In other cases, less pervasive problems that did not require significant contract modifications or substantial additional exchange analysis were communicated to an exchange informally by telephone, and the exchange replied within a specified period without any interruption of the one-year review period.

In addition to providing exchanges with a new degree of assurance that their applications will be expeditiously processed, we believe the amendment also provides clarity to the designation process by delineating the exchanges' responsibility for contract justification and the Commission's responsibility for review.

B. 180-Day Time Limitation for CFTC Review of Proposed Exchange Rule Changes

Section 5a(12) of the Act, which outlines procedures for Commission review of proposed exchange rule changes, was substantially restructured by the 1982 Act. In addition to reducing the number of rule changes that must undergo extensive Commission review, the 1982 amendments limited to 180 days the time the Commission may take to consider proposed rule changes of contract markets.

I am pleased to report that the Commission and its staff have adapted successfully to the constraints imposed on the rule review process by the 1982 amendments. In particular, the Commission has made numerous changes to streamline the rule approval process. Accordingly, the staff has been delegated authority to approve many routine, non-substantive rule amendments. Further, the Commission has recently adopted new rules that grant advance approval to certain types of routine, non-discretionary exchange rule amendments.

The Commission has approved over 1,278 proposed exchange rules and rule amendments in the three years since this change to the Commodity Exchange Act became effective. This figure does not include the hundreds of rules and rule amendments that have been approved in conjunction with the designation of new contract markets.

Our data reveal that action was taken on approximately 43 percent of proposed exchange rule submissions within one month and an additional 26 percent within three months. Of the remaining 31 percent of the submissions, roughly one-third (11 percent of total submissions) required the full six months. Those rule submissions which did take over six months, such as the linkage between the

Chicago Mercantile Exchange and the Singapore International Monetary Exchange, were all completed under voluntary time extensions agreed to by the exchanges involved.

C. Reparations Program

Congress also authorized changes in the Commission's reparations program in the Futures Trading Act of 1982. Those changes have been incorporated into our rules and regulations and have been effective since April 23, 1984.

The new rules created an entirely new voluntary decision procedure, analogous to arbitration, in which the parties unanimously elect to have a Commission Judgment Officer decide their dispute on the basis of documentary evidence and pleadings. The decision is not appealable to the Commission or a U.S. Court of Appeals. Approximately 20 percent of the cases filed since the new rules became effective have been processed through the voluntary procedure. The new rules also retain the summary procedure, in which decisions may be rendered upon documentary proof only, and the formal procedure, where oral hearings before an Administrative Law Judge are routinely held. However, the monetary limit for claims qualifying for the formal procedure has been raised from $5,000 to $10,000.

Among other things, the new rules also: (1) authorize motions for dismissal after a case has been assigned to a Judgment Officer or ALJ; (2) require expedited discovery; (3) limit to twenty major U.S. cities the possible locations for reparation hearings; (4) authorize dismissal of parallel proceedings; (5) delegate authority to the Chief of the Opinions Section to rule upon procedural motions in cases that have been appealed to the Commission; and (6) provide for direct appeals to the Commission rather than a two-step petition process.

The Commission believes the new rules have been beneficial. Because the quality of complaints filed with the Commission is higher, fewer cases are being terminated. Of the 454 complaints filed in FY 1985, only 82 were terminated due to lack of jurisdiction or deficiencies in the filing. The increased quality of the complaints is due to increased communication with the public through responses to about 6,400 phone calls, 800 letters, and requests for 1,700 brochures per year.

Those cases which are filed are receiving expeditious treatment. Once any deficiencies in the filing have been corrected and all respondents have filed answers, the complaints are forwarded for disposition. The disposition of cases in the voluntary proceedings is taking an average of 75 days; cases forwarded for summary or formal proceedings are taking about 136 days, on the average.

Since the new rules have gone into effect, the Administrative Law Judges and Judgment Officers have made major strides toward reducing the backlog of cases awaiting disposition. On March 31, 1984, (three weeks prior to the effective date of the new rules), these presiding officers collectively had a caseload of 905 cases. As of June 30, 1985, this figure had declined to 514. Correspondingly, the time from when a case is assigned to an Administrative Law Judge or a Judgment Officer to when a decision is rendered has decreased significantly.

As for the Commission's appellate docket, the number of reparations appeals has remained fairly constant over the last three years: 136 matters were filed in Fiscal Year 1983; 126 were filed in Fiscal Year 1984; and 139 were filed in Fiscal Year 1985. In contrast, Commission productivity (defined in terms of outgoing CFTC appellate opinions and orders) has nearly doubled over the same period: 108 orders and opinions were issued in reparations cases during Fiscal Year 1983; 168 such orders and opinions were issued in Fiscal Year 1984; and 195 such orders and opinions were issued in Fiscal Year 1985. This rate of Commission productivity is the highest in the agency's history.

The total backlog of reparation cases on the CFTC's appellate docket has decreased from 177 cases on September 30, 1983, to 135 cases on September 30, 1984, and to 101 cases on September 30, 1985. Moreover, the relative age of the appellate backlog is decreasing steadily. On September 30, 1984, there were 51 reparation appeals that had been pending on the Commission's appellate docket for more than one year. By September 30, 1985, no reparation case was pending on appeal for more than one year, and the median age of all such cases on the Commission's docket was six months.

D. SEC-CFTC Relations

Since the enactment of the jurisdictional accord in the 1982 amendments, the Securities and Exchange Commission and the CFTC have continued their cooperative relationship, which has become more structured under the terms of the accord. Certainly, before the accord, the CFTC sought comment on applications relating to exempt securities and financial instruments which might have affected SEC regulatory oversight in the securities markets. But, because the SEC now has an enhanced statutory role in the consideration of futures contracts on stock indexes, the CFTC-SEC relationship is more formal.

The staffs of the Commission and the SEC meet regularly to assure regulatory coordination between the two agencies. One topic of these discussions has been the "third Friday phenomenon." As you may have read in the business and financial press recently, concern has been expressed about volatility in the underlying stock market during the last trading day of the stock index futures and option markets. The Commission and the SEC are considering this development to determine the appropriate regulatory response. Futures market participants in certain over-the-counter stock index contracts presently are required to decrease market positions to prescribed limits as the expiration day approaches. While the Commission is monitoring the effects of this "telescoping" of positions, the limited trading activity in these over-the-counter contracts to date has precluded an empirical assessment of the effects and effectiveness of these regulations.

E. Federal/State Relations

The Futures Trading Act of 1982 contained three major statutory amendments designed to involve the states more extensively in actions against those who engage in unlawful conduct with a "commodity" theme. First, a new "open season" provision was added as Section 12(e) of the Act, which authorizes state officials to enforce their own laws against persons engaging in unlawful commodity transactions or persons who are required to be registered under the Act but are not. Under this amendment, state law enforcement agencies have been empowered to use any available state law or regulation to combat "off-exchange" fraud involving commodities. Second, state law enforcement in this area was enhanced by amendments to Section 8 of the Act, under which the Commission was expressly authorized to provide registration and other information to the states for law enforcement purposes, including information contained in otherwise confidential investigative files. And third, Section 6d(8) of the Act empowers state officials to proceed in state court against Commission registrants (except floor brokers or a registered futures association) for violations of any antifraud provision of the Act or any Commission antifraud rule, regulation or order.

In May 1984, the Commission's Division of Enforcement established a specialized unit to promote and foster cooperation and information sharing with the states as well as prosecution by the states, the Commission and other federal agencies of off-exchange and other illegal activity. This State/Federal Liaison Unit has compiled a central file which eventually will contain information on all known or suspected off-exchange commodity "boiler-room" operators in the United States. Since its inception, the Unit has shared information from its files with California, Colorado, Arizona, Michigan, New York, Ohio, Missouri, Texas, Virginia, Maine, Montana, North Carolina, Nevada, Georgia, Wyoming and Florida. The Unit also has prepared and coordinated the furnishing of expert legal and economic analyses to Illinois, New Mexico, Texas, and Wisconsin, and has shared information with the U.S. Postal Inspectors, the Federal Bureau of Investigation, the Internal Revenue Service, the Department of Justice fraud section, and numerous U.S. Attorney's offices.

One of the most vital functions served by the Unit is the investigation and prosecution of boiler-room operators through injunctive actions, both in conjunction with state officials and on its own. Since its inception, the

Unit has filed 11 actions against illegal off-exchange boiler-rooms, six of which were joint actions brought with the states. In addition, the Unit has been involved in joint investigations with Arizona and Texas. Other units of the Division of Enforcement have filed joint actions with Arizona, Illinois and Texas against boiler-room operations.

CFTC relations with the states have been excellent since the passage of the amendments contained in the Futures Trading Act of 1982. The Commission has filed a total of 20 injunctive actions against off-exchange operations since the passage of those amendments. Twelve of the actions were joint, co-plaintiff actions with the states. Joint federal and state action and cooperation is truly making inroads on the nationwide problem of illegal commodity-related frauds.

In the interest of furthering federal/state cooperation, the Commission's Division of Enforcement recently held the Fourth Annual Enforcement Seminar in Washington, D. C., which was attended by officials from 24 states and Canada. A mid-winter enforcement seminar was held in Portland, Oregon, February 18 and 19, and another seminar is scheduled for Los Angeles later this month. That seminar will be presented to representatives of the Investment Fraud Task Force, which is comprised of state and federal law enforcement officials in Southern California.

The new cooperative spirit that exists between the states and the Commission is reflected also in the Model State Commodity Code, which the North American Securities Administrators Association (NASAA) adopted on April 5, 1985. The Code is designed as a modern "bucket shop" law to prohibit those commodity transactions which have been fraught with customer abuse. At the same time, the Code complements the Commodity Exchange Act by acknowledging legitimate commodity instruments regulated under federal law and by permitting the public to acquire commodities under specific terms of the Code.

The Code is the product of more than a year's effort by the NASAA Commodities Committee, with assistance from the staff of the Commission and the National Futures Association. The Commission has pledged to NASAA its assistance in having the Code introduced and passed in as many state legislatures as possible. Versions of the Code have already been enacted in New Mexico and Missouri and are actively being considered by several other states.

Another symbol of the efforts the CFTC and the states have made in recent years is the ongoing work of the Commission's Advisory Committee on CFTC-State Cooperation. The Committee, which is comprised of federal and state law enforcement officials and representatives of the private sector, was created to discuss and offer advice on matters which concern both the states and the Commission under the Commodity Exchange Act. In November 1985 the Committee held its annual meeting in Washington to discuss CFTC-state enforcement issues and the CFTC state/federal liaison unit, criminal enforcement, the National Futures Association, and the North American Securities Administrators Association's Model Code.

F. Exclusion of Certain Persons from the Definition of Commodity Pool Operator

In connection with the adoption of the Futures Trading Act of 1982, the Senate Committee on Agriculture, Nutrition, and Forestry considered an amendment to the Commodity Exchange Act which would have exempted certain otherwise regulated entities from the definition of a commodity pool operator. In lieu of adopting such an amendment, the Committee urged the Commission to issue regulations which would have the effect of providing this relief. On April 23, 1985, the Commission adopted Rule 4.5, which excludes from the definition of a commodity pool operator, subject to certain conditions, banks and other financial depository institutions, trust companies, insurance companies, and numerous ERISA pension plans that use commodity interests in their management of cash portfolios. The Commission believes that the adoption of Rule 4.5 has addressed a major area of concern to these "otherwise regulated entities" and, as a result, has eliminated any major problems of duplicative regulation in this area.

G. Studies Mandated By Congress

In connection with the Commission's reauthorization in 1982, the Congress directed the Commission to study and report on four areas of Congressional concern. The Commission separately has forwarded to the Congress final reports on these studies. The purposes and conclusions of these studies are outlined below.

1. The Potential for Insider Trading in the Commodity Markets

One of the concerns Congress expressed during the 1982 reauthorization was the potential problem of individuals trading futures contracts based on material, nonpublic information. Congress asked the Commission to analyze this issue and the adequacy of the Commission's authority to prevent market and customer abuse as a result of trading on nonpublic information.

The Commission examined trading by (1) government employees who obtain information as a result of their employment; (2) employees of self-regulatory organizations, including their staffs and governing bodies, who obtain information as a result of their regulatory activities; (3) individuals who obtain nonpublic information as agents trading for their customers in the futures markets; and (4) others, including employees of firms who trade in the cash and futures markets.

The Commission determined that certain traditional notions concerning the legal requirements for establishing insider trading under the securities law are of limited application to the futures markets. The Commission concluded that provisions of existing commodities law adequately discourage government employees from using material, nonpublic information relevant to futures markets. With respect to employees and board members of futures self-regulatory organizations, the Commission noted that many such organizations have adopted a variety of restrictions against such trading.

In the interest of uniformity of regulation, the Commission has proposed rules that would make it a violation of CFTC regulations for employees of self-regulatory organizations to disclose material, nonpublic information obtained through their employment. The Commission has proposed, further, that self-regulatory organizations adopt rules to prohibit their employees from disclosing or trading on material, nonpublic information. In addition, the Commission's proposed rules would prohibit members of contract market or clearing organization governing boards or committees from trading in certain markets prior to the announcement of regulatory decisions by such bodies affecting those markets, and would bar them from disclosing information about the regulatory decisions. The Commission's proposed rules in this area are expected to be published in final form in the near future.

Among the possible types of customer and market abuses arising from insider trading in futures markets, historically there has existed particular concern about the potential harm of trading by floor brokers or other fiduciaries for their own accounts while having knowledge of the customer orders they are filling — a practice known as "dual trading." While Commission and exchange rules require, among other things, that floor brokers execute customers' orders before trading for their own accounts, many exchanges have deficiencies in their trade reconstruction systems that have created difficulties in enforcing such rules in a timely and effective manner. To remedy this situation, and for other reasons, the Commission recently adopted new audit trail rules, which I will discuss later in my testimony.

The study focused also on the potential extent and effects of insider trading by directors, officers and employees of firms whose businesses involve the commodities underlying futures contracts, or by employees of firms issuing reports that may affect the market. The Commission is aware of the inherent problems in collecting information related to insider trading in futures markets by persons associated with cash market firms. However, on the basis of the findings in this study and because the study provides no significant evidence of such insider trading, the Commission is not recommending any legislative changes in this area.

The Commission will continue to watch for potential market abuses in this area and will be prepared to make any appropriate recommendations to the Congress in light of future Commission findings.

2. The Impact of Large Hedgers in the Livestock Futures Markets

The Congress in 1982 addressed its concerns about livestock futures markets by directing the Commission to conduct a two-year study of the manner in which large hedgers use the futures markets in live cattle, live hogs and pork bellies. These futures contracts are traded on the Chicago Mercantile Exchange. This study examined the activities of hedgers in livestock futures markets from October 1982 through June 1984.

Section 4a(3) of the Commodity Exchange Act requires the Commission to exempt bona fide hedging transactions from any position limit rules it adopts. Since hedgers are exempt from position limits, they have the potential of acquiring greater market power than individual speculators and a greater capacity to affect -- and possibly to distort -- futures prices. Analysis of position data confirmed, however, that although hedgers frequently held large livestock futures positions, no commercial traders accounted for an excessively large share of the open interest in an expiring livestock future during the last few days of trading. Nor did traders appear to use their hedge exemptions to affect deferred futures prices.

The study concluded that the existing regulatory programs of the Commission and the CME are adequate to deter any abusive trading by large hedgers in livestock markets and to preserve or restore orderly trading in those markets.

3. National Futures Association

Congress directed the Commission to submit a report on the regulatory performance of National Futures Association by January 1, 1986. In its report the Commission concluded that NFA generally has succeeded in meeting its mandate under the Futures Trading Act of 1982 to adopt and, with certain exceptions, to implement a comprehensive self-regulatory program in the public interest.

By September 30, 1985, NFA had put into place a program reasonably designed to result in effective fulfillment of each of the specific objectives established by the Futures Trading Act of 1982. NFA has promulgated rules in each of the program areas specified in the 1982 legislation — proficiency standards and testing; minimum capital, segregation, and other financial requirements; and sales practices — and has also implemented effective arbitration, membership and disciplinary programs necessary to its continued registration under the Act. NFA has also initiated effective sales practice and financial audit programs for those of its members which are not also exchange members.

Certain aspects of NFA's self-regulatory program are not yet fully operational, however. In particular, as of September 30, 1985 (the end of the statutory evaluation period), a segregation audit program covering that portion of NFA's membership which also belongs to one of the commodity exchanges had only been in place for two months; similarly, while one exchange had voluntarily initiated a branch office sales practice examination program, NFA was only then concluding its agreements with four of the exchanges to conduct sales practice audits on NFA's behalf. Conclusions about the ultimate quality and effectiveness of these critical programs, therefore, cannot be drawn at this time.

In this connection, the Commission expects to continue to audit NFA's programs periodically as it does the programs of the contract markets. To facilitate this oversight process, the Commission is proposing statutory revisions to assure that its authority with respect to NFA is consistent with and at least as effective as its already-existing authority with respect to the designated commodity exchanges.

The impact on the Commission's operations as a result of the successful implementation of NFA's programs thus far has been material. Relieved of several resource-intensive functions and responsibility for most direct regulation, the Commission has been able to address its primary regulatory responsibilities in a more efficient and expeditious manner, to upgrade the quality of its oversight efforts, and to prepare for and react to innovation and substantial growth in the industry without a comparable expansion of its staff. This redirection of Commission energies has enhanced performance of the Commission's primary functions of oversight, market surveillance, enforcement, and policy development.

In measuring the cost savings attributable to the operations and activities of NFA, the Commission has endeavored to quantify the direct, tangible savings that resulted from the transfer to NFA of various functions, such as registration processing, which had formerly been performed by the Commission. The direct savings to the Commission that have thus far resulted from the implementation of NFA's regulatory program, representing actual Commission staff and other resources formerly dedicated to functions that have been transferred to NFA and which have now been redirected to other Commission priorities or eliminated, were estimated to total $3.5 million during the three-year period from fiscal year 1983 through fiscal year 1985.

During the same period, the Commission, the industry and the general public benefitted indirectly from a number of new activities undertaken by NFA, including NFA's initiatives in the areas of proficiency testing, registration of introducing brokers and their associated persons, and auditing and sales practice monitoring of introducing brokers, all of which were areas in which the Commission never established an operating program of its own.

Estimating the value of these benefits was a difficult aspect of the Congressional directive that the Commission estimate the projected cost savings to the Federal Government resulting from NFA's activities. The problem was that the budgets of the Commission and NFA cannot be compared directly. Factors such as federal limitations on compensation and travel expenditures, limitations on federal appropriations, differences in the experience levels and relative efficiency of the Commission and NFA staffs, and differences in start-up versus ongoing costs added to the difficulty. Nevertheless, the Commission estimates that NFA's undertaking of these activities has enabled the Commission to avoid making additional appropriation requests over the last three fiscal years in order to fund these oversight activities, for which NFA expended $16.2 million.

In conclusion, the Commission has determined that NFA's various self-regulatory programs generally meet the minimum requirements established by the Congress and the Commission. These programs, however, are evolving, not static, and the Commission expects that they will be supplemented and become even more effective in the years ahead. The Commission therefore expects to continue to monitor NFA's further progress in order to ensure that NFA continues to perform adequately and properly implements the comprehensive program specified in the Act.

4. The Economic Effects of Futures and Options Trading

On December 31, 1984, the Commission, along with the Securities and Exchange Commission and the Federal Reserve Board, submitted to the Congress our report on a study of the economic impact of futures and options trading. The study was the joint effort of the three agencies with assistance from the Treasury Department.

The study concluded that the new financial futures and option markets serve a useful economic purpose, primarily by providing a means by which risks inherent in economic activity can be transferred from firms and other commercial entities less willing to bear them to those more willing and able to do so. As a result, these new derivative markets make it possible to fix the price at which an asset can be bought or sold in the future or the interest rate at which money can be borrowed or lent. This desirable risk transfer function appears likely to spread to additional commercial and financial firms and increase in magnitude as experience is gained with these new markets and legal impediments to their use are modified.

The study also concluded that financial futures and options markets appear to have no measurable negative influence on capital formation. Because options and futures markets do not absorb the real savings of society, these markets do not affect the total volume of funds available to financial markets. The new markets for financial futures and options appear to have enhanced liquidity in some of the underlying cash markets on which they are based and do not appear to have reduced the liquidity of any of these markets.

As a separate matter, the study concluded that trading in the functionally similar instruments under the jurisdiction of the SEC and CFTC has not harmed public customers or the derivative or related cash markets. The study reiterated both agencies' commitment to work cooperatively to establish a compatible framework of regulation to deal with activities requiring such supervision and regulation.

H. Introducing Brokers

Prior to 1982, the Act did not require the agents of futures commission merchants to be registered with the Commission in any capacity. Congress corrected this gap in 1982, however, and at the request of the industry created a new category of registrant, the introducing broker. Final rules governing the registration and regulation of introducing brokers and their associated persons were promulgated on August 3, 1983.

The major difficulty the Commission encountered in developing its rules in this area was the diversity of this class of registrant. For example, introducing brokers may be single-person offices, grain elevator operators, or securities broker-dealers who do not wish to establish a separate commodities business but prefer simply to refer business to a registered futures commission merchant. The Commission believes it has been successful in accommodating the interests of this diverse group in its regulations.

Capital requirements are an area where certain adjustments to the regulations were made to accommodate the variety of introducing broker applicants. In establishing the introducing broker category of registrant, Congress instructed the Commission that the minimum financial requirements for introducing brokers should "effectuate the Congressional purpose that introducing brokers have a sufficient reserve of capital to remain economically viable yet...not be so onerous as to constitute a barrier to the entry into, or continuation in, the commodities industry." Moreover, such financial requirements should "guarantee accountability and responsibile conduct of introducing brokers." In response, the Commission set the minimum net capital requirement at $20,000.

Nonetheless, the Commission found that many introducing brokers could not meet this requirement. As an alternative, therefore, Commission regulations permit an introducing broker to enter into a guarantee agreement with a futures commission merchant under which the futures commission merchant agrees to be jointly and severally liable for all obligations of the introducing broker under the Act and the Commission's rules, regulations and orders. The guarantee is intended to provide coverage for potential liabilities of the introducing broker arising from its business operations and customer relations.

The guarantee has become the primary means by which introducing brokers comply with the Commission's minimum financial requirements. In this connection, records maintained by NFA indicate that of the more than 900 introducing brokers, more than 700 are guaranteed by a futures commission merchant.

II. Ongoing CFTC Regulatory Initiatives

A. Audit Trail

The Commission recently adopted final rules designed to improve the trade-timing records of exchanges in order to achieve effective trade reconstruction. The rules require the actual execution time of each futures and option trade to be stated in one-minute increments on the trade register -- the required exchange transaction journal. Notably, the actual time the trade is executed need not be recorded by the trader. The regulation does not specify the method for meeting this trade-timing standard, but permits each exchange to comply with the standard as it chooses. Thus, the Commission adopted a "performance standard," rather than a "design standard. For instance, an exchange could use manual recordation, a technology-assisted system, exchangerecorded times, order "exit" times, or a combination of these or other approaches, so long as the Commission's trade-timing standard is met.

As part of its oversight responsibilities, the Commission always has monitored exchange trade reconstruction capabilities to determine exchanges' abilities to enforce certain trading rules consistent with the Commodity Exchange Act and CFTC rules and regulations. The new rules are an outgrowth of this ongoing review, particularly of the bracketing accuracy under the current requirement of 30-minute bracketing of trades, and of explicit Commission findings from its studies and investigations of certain markets and trading practices.

Specifically, in September 1984, the Commission's "insider trading" study concluded that 30-minute bracketing data is subject to inherent limitations in preventing or detecting and prosecuting trading abuses related to dual trading. These limitations made advisable rulemaking to require the exchanges to improve the speed and accuracy of reconstruction of trade sequences. The study also indicated that such rulemaking might consider permitting the exchanges to elect to bar dual trading in their markets.

Also in the fall of 1984, the Commission released a summary of its study of soybean futures trading on the CBT from August through December 1983. In the press release which accompanied this summary, the Commission emphasized the need for the commodity exchanges to develop detailed, accurate and automated audit trail systems to permit accurate analysis of intra-day trading patterns and their impact on intra-day price movements.

Prior to the completion of these studies, the Commission had requested a review of bracketing data as a result of exchange rule enforcement reviews in 1983. In particular, the Commission was concerned about the effective use of bracketing data under the self-regulatory requirements of the Act. The results of this review noted bracketing accuracy rates of approximately 70 percent at the larger exchanges and that certain exchanges did not appear to consider bracketing data particularly useful for conducting investigations. The issue of trade time recordation also was raised in January, 1984, when the Commission was asked to approve 30-minute bracketing rules for the New York Mercantile Exchange ("NYMEX"), which then had a pit slip system in which the time of the trade execution was recorded on the pit slip in one-minute increments. Despite Commission authorization of NYMEX's bracketing rules, NYMEX advised the Commission that it would continue to explore trade-timing alternatives and that it would not implement 30-minute bracketing. The NYMEX continues to use its pit slip system, even though it experienced a 36 percent growth in volume in 1984, and a 47 percent growth in 1985. Notably, two other exchanges, the Kansas City Board of Trade and the Minneapolis Grain Exchange, have one-minute manual timing systems. In addition, the Philadelphia Board of Trade and the Amex Commodities Corporation have one-minute trade-timing systems.

When the Commission proposed the amendments to audit trail reporting procedures, it noted some important benefits of the audit-trail improvements that could result from implementation of this rule. First, the more precise trade execution time standard should improve dramatically the surveillance capabilities and efficiency of both the exchanges and the Commission through improved detection of possible abuses. Trade reconstruction based on 30-minute bracketing, in many instances precludes, or makes difficult, determinations by investigators and by adjudicatory bodies whether a trading abuse or attempted manipulation has occurred. Second, the Commission noted that the new rules should have a deterrent effect as a result of the enhanced ability of the exchanges and the Commission to assure the integrity of the markets. A beneficial side effect also noted by the Commission may be increased confidence in the markets themselves.

Under the new rules, each exchange must determine and report to the Commission by July 1, 1986, the type of system it will adopt. The new rules require the exchanges to be fully operational by October 1, 1986, and using their enhanced audit trail data in their exchange compliance programs by January 1, 1987. The Commission believes that, particularly in light of the lengthy rulemaking process, this schedule provides sufficient time for the implementation of improved systems.

B. Volume Investors — A Regulatory View

In March 1985, Volume Investors Corporation, a clearing member FCM at the Commodity Exchange, Inc. (COMEX) and other exchanges, carrying accounts for approximately 100 public customers in regulated futures and option markets, defaulted on its obligations to the Comex clearinghouse. Three customers at Volume were holding uncovered short gold option positions totaling 12,000 contracts (representing 1.2 million ounces of gold) on March 18 and 19 when the price of gold experienced a sharp upward spike, rising $44 an ounce in two trading sessions and causing their positions to generate margin calls of over $26 million. These three customers defaulted on their margin calls to Volume, and Volume itself, a relatively small firm with net capital of only $2.5 million, was unable to absorb the loss. On Wednesday morning, March 20, the firm failed to meet its own margin obligations to the COMEX Clearing Association, which, nonetheless, continued to meet Volume's obligations to the other side of the market. Volume was left with about $10.1 million in assets to cover $13.7 million in obligations to customers, plus another $9.1 million in liabilities owed to exchange clearing organizations and $1.4 million owed to other FCMs, brokers, and general creditors.

CFTC staff was first informed of Volume's situation at about 9:30 a.m. on Wednesday, March 20, without any data on the firm's financial exposure. In order to obtain a clear assessment of the situation, auditors from the CFTC's New York regional office were directed to conduct an on-site investigation of the firm's books and records. When a deficiency of segregated funds to satisfy all of Volume's obligations to customers was found, the Commission acted to place the firm into judicial receivership, with the consent of Volume. Commission attorneys obtained the necessary legal order by consent from a U.S. District Judge at 8:30 a.m. on Thursday, March 21.

The Volume default prompted two immediate concerns for the Commission: first, that innocent non-defaulting Volume customers should not lose money as a result of the firm's demise, and second, to the extent that weaknesses in the regulatory structure contributed to the default, that these be corrected as quickly as possible. While the actual magnitude of customer equity frozen after the Volume default -- about $13.6 million -- was relatively small, another FCM failure could easily involve many times that amount.

Within days, Commission staff initiated an industry-wide review of regulatory safeguards for the financial integrity of industry firms and the protection of segregated customer funds. Based on the Commission's review of the incident, each designated exchange received a letter from the Commission outlining its recommendations for improved financial surveillance of the markets. In response, six exchanges, including COMEX, agreed during this period to amend their rules to establish minimum margin levels for out-of-the-money short option positions, and the COMEX Clearing Association also proposed to extend its system of capital-based position limits for futures positions to the option markets.

Having obtained a receiver for Volume, the Commission participated in the receivership proceeding, as requested by the court. In October, the receiver conducted an interim and partial distribution of approximately $7 million in Volume assets under which customers received approximately half of their mid-March account equity. In August, an agreement was reached under which Volume's principals, Owen Morrissey and Charles Federbush, would contribute $4.1 million to cover the firm's obligations, which with remaining Volume assets of about $2.5 million would make a full customer reimbursement possible. This agreement dissolved in November, however, when Mr. Morrissey withdrew from the plan after certain customer releases called for in the agreement were not forthcoming. Most recently, in December, COMEX and Mr. Federbush agreed to provide Volume $4.1 million to complete the customer distribution, and an agreement was reached, subject to court approval, with two of the original defaulting Volume customers to pay $5 million in settlement of their original liabilities.

Based on its continuing investigation of the affair, the Commission's Division of Enforcement filed an administrative complaint on August 27 against COMEX, the COMEX Clearing Association, Volume Investors, and various individuals, alleging violations of the Act and applicable regulations in connection with the default.

On July 29, the CFTC Division of Trading and Markets reported to the Commission on its examination of the Volume default. The principal recommendation of the report was that the Commission adopt regulations correlating the market exposure which any firm is permitted to carry to the amount of a firm's net capital.

The Volume Investors situation demonstrated that if a customer default causes a deficit which is so severe that an FCM cannot cover the deficit from its own funds, the non-defaulting customers of that FCM will have their funds tied up pending litigation of the firm's claim against the defaulting customer, unless money to cover that deficit can be found elsewhere. As it is the financial integrity of a firm that stands behind customer funds, FCMs are required to meet a minimum net capital standard. The Commission now believes that capital level should more precisely reflect the risk of positions carried by the firm. The comment period on proposed new capital rules that address this issue has been extended to April 4.

In its July 1985 report on Volume Investors, the Commission's Division of Trading and Markets also proposed that the Commission articulate its standards for reviewing exchanges' margin rule systems to provide that (1) option purchasers must pay the full premium price at the time of purchase and not receive gains until the position is liquidated, (2) for short options, the required margin must be a reasonable amount in addition to the premium received on the option sale and, for covered positions, the cover must be in the possession or control of the FCM carrying the position, and (3) for exchange members, advantageous margin rules may be permitted to encourage liquidity or other desirable market effects, but only so long as they meet minimum standards. This margin guideline was published for comment August 5, 1985. Several commenters suggested that final action on the proposed guideline be addressed concurrently with action on a rule to permit application of futures-style margining to options, as proposed by the Commission on March 9, 1984. Currently, industry representatives are working to develop a consensus view on the futures-style margining issue.

To remedy certain weaknesses in exchange financial surveillance systems, the staff in July 1985 also issued a significant revision to its Financial and Segregation Interpretation 4, which governs how exchanges and clearing organizations oversee member compliance with minimum financial, segregation, and other requirements. The revised interpretation, among other things, requires that open positions at member FCMs are monitored on a daily basis to assess the potential impact of possible price movements on the financial integrity of the firm. This interpretation is now being implemented at each designated exchange, and Commission staff is monitoring compliance with the new standards.

Commission staff also suggested that the Commission request the National Futures Association to examine the possible role of customer account insurance as a safety net to protect customers in regulated futures and option markets against losses due to failures by industry firms, and an NFA study on the matter is currently underway.

C. Option Pilot Program

On November 3, 1981, the Commission published final rules establishing a strictly controlled, three-year pilot program to permit exchange-traded commodity options. Initially, the pilot program permitted each exchange to trade one option on a commodity futures contract on other than domestic agricultural commodities. In September 1982 the Commission designated the first options under the pilot program -- options on sugar, gold and Treasury bond futures.

The Commission has monitored trading closely in the originally designated options, and based upon the absence of significant customer or other abuses, has expanded the pilot program so that at present each exchange may trade up to eight options, including up to two options on physical commodities. Currently, sixteen options have been designated to trade under the pilot program, including in addition to those initially approved, options on stock indexes, silver, Treasury-notes, Eurodollars, foreign currency and cocoa futures contracts, and options on gold and Eurodollar physicals.

Following the 1982 repeal by Congress of the 1936 statutory ban on options involving domestic agricultural commodities, a separate three-year pilot program for the trading of options on those commodities was adopted on January 23, 1984. Under this pilot program, each exchange could be designated for two options on domestic agricultural futures contracts and the first contracts began trading in October 1984. Currently, ten options, including the grains, livestock, cotton and frozen concentrated orange juice, are trading under this pilot program, and the Commission is considering whether a further expansion of this program is warranted.

The Commission's pilot program for exchange-traded options has resulted in a phased expansion of commodity option trading in the United States. By permitting phased expansion only after obtaining increasing experience in trading, the Commission has assured itself that the public would be protected from the types of abuses which previously plagued the off-exchange offer and sale of such options. Now that the initial three-year test period has concluded, the Commission is evaluating the overall experience of trading under the pilot program and will be determining whether different or additional rules are appropriate.

D. Internationalization of the Markets -- Regulatory Implications

Increasingly, the commodity markets are assuming a growing international dimension and the Commission is playing a vital role in accommodating this expansion through appropriate regulatory changes and proper oversight. In August 1984, the Commission approved contract market rules establishing one international link -- the "mutual offset system" developed by the Chicago Mercantile Exchange and the Singapore International Monetary Exchange, Ltd. Currently, the Commission is reviewing proposed rules which would establish the second such link, in this case between the Commodity Exchange, Inc. and the Sydney Futures Exchange, Ltd.

Because the CME-SIMEX arrangement was the first of its kind involving a U.S. exchange, the Commission was in uncharted waters as it proceeded to analyze the issues presented by such a novel and complex arrangement. The Commission's review of that proposal endeavored to ensure that the planned linkage would not adversely affect the integrity of the domestic market. As a consequence, the Commission carefully analyzed every facet of the proposal, including: the financial safeguards for the CME, its clearing members and their customers; the large trader reporting, speculative position limit, and contract delivery provisions; the protections and remedies available to domestic users of such a linkage; and the effects of foreign and international law, especially with respect to the Commission's ability to obtain potentially significant market surveillance information.

In the interest of assuring access to market surveillance data, the Commission has formed a cooperative arrangement with the Monetary Authority of Singapore and is developing working relationships with its counterpart agencies in more than a dozen foreign countries. As a result, the Commission has gained invaluable experience in analyzing and commenting upon new developments in the international arena, including the regulatory and self-regulatory systems now being developed in Great Britain and Australia.

III. 1986 Reauthorization: the CFTC Proposal

A. Enforcement; Appellate Review

1. Section 4b Prohibition of Fraud in All Futures Contracts

One of the Commission's proposed amendments would alter Section 4b of the Act, which generally prohibits any person from cheating or defrauding any other person "in or in connection with any order to make, or the making of, any contract of sale of a commodity for future delivery, made, or to be made, on or subject to the rules of any contract market...." [Emphasis added.] Our proposed amendment would delete the underlined language, making the antifraud provision of Section 4b expressly applicable to any commodity futures transaction, regardless of whether executed on or subject to the rules of a contract market.

Several courts have entered injunctions against further violations of Section 4b in cases brought by the Commission involving the off-exchange sale of futures contracts. Nonetheless, the Commission is concerned that the language of Section 4b might be interpreted narrowly to limit its authority to exchange-traded futures, resulting in a court's refusal to apply Section 4b to the sale of off-exchange futures contracts. The proposed amendment would simply codify the Commission's interpretation of Section 4b and make it consistent with other antifraud provisions of the Act and Commission rules, which are not limited to transactions conducted on a contract market.

The amendment would not expand the Commission's jurisdiction. As noted in the 1982 reauthorization process, the Commission strongly encourages individual states to play an active role in stopping off-exchange fraud operations doing business in their state. This amendment would simply make it clear that both the Commission and the states have the authority to prosecute fraud committed by off-exchange operators.

2. Extraterritorial Service of Subpoenas

The Commission proposes to amend Section 6(b) of the Commodity Exchange Act specifically to authorize the Commission to serve investigatory and other administrative subpoenas on persons outside the territorial United States. We believe the proposed change is necessary because in a recent decision the U.S. Court of Appeals for the District of Columbia Circuit ruled that Section 6(b), as presently drafted, does not authorize enforcement of an investigatory subpoena served on a foreign citizen in a foreign country.

In the course of its investigation of events in the U.S. silver market during 1979 and 1980, the Commission had cause to believe that one of the principal participants in the market was Naji Robert Nahas, a dual citizen of Brazil and Lebanon, then residing in Brazil. In 1983 the Commission issued a subpoena directing Nahas to appear with his records of relevant transactions at the Commission's offices in Washington. The subpoena was served upon Nahas in Sao Paulo. The Commission had retained a Brazilian attorney to serve the subpoena at the suggestion of the U.S. Department of State. When Nahas failed to respond to the subpoena, the Commission filed suit in the U.S. District Court for the District of Columbia to enforce the subpoena. When Nahas failed to comply with the court's order enforcing the subpoena, the court found Nahas in contempt. However, the U.S. Court of Appeals for the District of Columbia Circuit later overturned the district court's decision, holding that Section 6(b) of the Act did not authorize enforcement of an investigatory subpoena served on a foreign citizen in a foreign country. The appeals court did not question the authority of Congress to so authorize the Commission, but rather ruled that Congress had not granted such authority when it enacted Section 6(b).

If allowed to stand, the Court of Appeals' ruling may foreclose the Commission from investigating the conduct of foreign market participants, regardless of the magnitude of their involvement in U.S. markets, so long as they, or other witnesses, remain outside the territorial United States. Under this ruling, even though a foreign participant's conduct is clearly subject to the requirements of the CEA, and despite the existence of sufficient contacts with the United States to establish _in personam_ jurisdiction as a matter of due process, the foreign participant may only be subject to the Commission's subpoena power if service can be made in the territorial United States. The Commission does not believe Congress intended this result.

3. Review of the CFTC Orders in Courts of Appeal

Some types of final Commission orders are, pursuant to specific sections of the Act, subject to judicial review only in the United States Courts of Appeal. Other types of final Commission orders, about which the Act is silent on the forum for judicial review, are governed by the provisions of the Administrative Procedure Act. Under the APA, judicial review typically begins in the U.S. District Courts. One of the amendments to the Act proposed by the Commission would add a new section to the Act providing that persons aggrieved by a final Commission order or rule may obtain review of that order or rule only in the United States Courts of Appeal.

In the course of issuing many of its final orders and rules, the Commission employs a number of administrative procedures that, in many ways, are analogous to the function of the district court in gathering and weighing evidence in disputed matters. In its rulemaking function the Commission also reviews the facts developed through the comment process before adopting its final rules. And in reviewing the actions of self-regulatory organizations, the Commission reviews the facts developed in the organization's proceeding. In each of these situations the Commission develops or reviews an adjudicatory or administrative record before issuing its rule or order. If a person believed that the Commission acted without authority or erred in its decisionmaking, the Commission's proposed amendment would eliminate the need for review in the district court. Review by a court of appeals, which simply reviews the complete record and does not attempt to reconstruct or supplement evidence used in the Commission's decisionmaking, would provide for a definitive ruling more promptly and save judicial and Commission resources, as well as the resources of the aggrieved party.

The idea of consolidating in the Courts of Appeal the judicial review of all rules or orders issued under a statute is not novel. For example, several statutes enforced by the Securities and Exchange Commission all contain a provision that provides for judicial review solely by the U.S. Courts of Appeal. Further, the trend in courts' interpretation of judicial review provisions is to encourage plaintiffs to take their grievances through the administrative appeal procedures directly to a court of appeals, rather than through both administrative appeal and a district court proceeding before going to the court of appeals.

4. Statutory Authority to Obtain Ex Parte Appointment of Receiver

Section 6c of the Commodity Exchange Act authorizes the Commission on an *ex parte* basis to obtain a restraining order to freeze the assets of persons it believes have engaged in or are about to engage in a violation of the Act or Commission rules, and to prevent such persons from destroying books and records. As the section is presently written, there is no express power for the court to appoint a receiver on an *ex parte* basis to protect and manage the business of the entity subject to the freeze order. The Commission proposes to amend Section 6c to authorize the *ex parte* appointment of a temporary receiver pending a hearing to decide whether a permanent receiver should be appointed or such other hearing as the court may order.

In many instances in which the Commission takes enforcement action against an off-exchange operation, the Commission will seek to obtain an *ex parte* restraining order to protect books and records and to freeze the operation's assets, but no independent person is in place to ensure that the books and records and assets are protected, and in some cases, to preserve assets by making day-to-day business decisions until a permanent receiver can be appointed. In at least one case, it is suspected that a defendant disposed of books and records and transferred the assets of a defendant after an *ex parte* order was issued.

Often, the period between issuance of the *ex parte* restraining order and the hearing on the application for appointment of a receiver can be as long as 15 to 20 days. During that time, the restrained operation may hold open positions in the futures market that would go unmanaged or be liquidated for failure to meet a margin call. In addition, while assets are frozen, employee salaries may go unpaid and employees may quit, further limiting the ability of the operation to preserve any assets it may have. A temporary receiver could pay salaries and other legitimate expenditures, meet margin calls or liquidate unprofitable positions, and otherwise protect the assets of the operation for ultimate distribution to customers.

B. Leverage Transactions

Another proposal in our legislative package would amend the Commodity Exchange Act to exclude entirely leverage transactions from regulation under the Act. Under this amendment the Commission would neither be required nor authorized to regulate leverage transactions as a distinct form of commodity instrument.

In order to place this proposal in perspective, it may be helpful to consider briefly the history of leverage and its regulation. In the Commodity Futures Trading Commission Act of 1974, the Commission was first given exclusive regulatory jurisdiction over gold and silver leverage transactions. In 1978 Congress banned leverage transactions in agricultural commodities and extended the Commission's exclusive leverage jurisdiction to all other commodities, in addition to gold and silver. Between 1974 and 1982, the Commission adopted three regulatory measures for leverage transactions: two temporary moratoria on the entry of persons into leverage businesses involving gold and silver bullion or coins or other commodities, and an antifraud rule.

With the enactment of the Futures Trading Act of 1982, Congress significantly amended the Commission's authority to regulate leverage contracts. Previously, the Commodity Exchange Act required that any leverage transaction determined by the Commission to be a contract for future delivery within the meaning of the Act be regulated as such. The 1982 Act, however, repealed this provision. In its place, Congress enacted a new Section 19(c) specifically to require the Commission to regulate leverage transactions in gold or silver bullion or bulk coins or in any other commodities, except those subject to the 1978 prohibition on agricultural leverage transactions. New Section 19(c) also vested in the Commission the authority to prohibit any leverage transaction for the delivery of any commodity that was not permitted by the rules, regulations and orders of the Commission in effect on December 9, 1982, if the Commission determines that such transactions would be contrary to the public interest.

As a result of the direction given by Congress in 1982, the Commission in 1984 and 1985 issued interim final leverage regulations for long and short leverage transactions in gold and silver bullion and coins, copper, platinum and certain foreign currencies. The development and administration of this program has been both time consuming and labor intensive, involving direct regulation of the operations of individual firms.

Following its experience with leverage regulation, and in view of current constraints, the Commission now requests amendments that would eliminate federal leverage regulation, and would remove from the Act virtually all references to leverage transactions. The amendments would eliminate what the Commission perceives as the historical and unjustified statutory distinction between leverage and futures contracts. In the Commission's view, leverage transactions are legally and economically indistinguishable from futures contracts and therefore do not warrant separate statutory treatment.

Under the proposed amendment, the Commission would remain authorized to bring law enforcement proceedings against those firms marketing off-exchange futures contracts, including leverage contracts, and the states, in addition to initiating or participating with the Commission in such enforcement proceedings, could enact and enforce legislation prohibiting the marketing of those contracts. However, if the proposal is enacted, the Commission believes that those firms which the Commission has registered as leverage transaction merchants under its existing regulations should be afforded a sufficient period of time to modify their businesses to remain in full compliance with the law. To this end, language could be included in the Committee reports accompanying the legislation expressing the intent of Congress that the Commission refrain from taking any enforcement action against such firms based solely on their continued offer or sale of leverage contracts or servicing of existing accounts during the period from enactment of the bill until, for example, January 1, 1988.

In this connection, the Commission points out that the amendment would not necessarily terminate the business of these firms. Specifically, it may be possible that the current leverage firms could, albeit with some modifications to their operations, continue in business by undertaking the marketing of cash and/or installment sale transactions. While this business would be subject to any existing state regulation, such cash and installment transactions would be permissible even in states that had adopted the North American Securities Administrators Association Model State Commodity Code.

In general, the Model Code is designed as a modern bucket shop law to prohibit the types of off-exchange commodity transactions which have been fraught with customer abuses. Nevertheless, the Code does permit the marketing of any commodity contract for the purchase of precious metals which requires, and under which the purchaser receives, within seven calendar days from the payment of any portion of the purchase price, physical delivery of the quantity of precious metals purchased by the payment. In this regard, physical delivery is deemed to have occurred if, within the seven day period, the precious metals purchased are delivered to a financial institution or other specified entity other than the seller. In addition, the Model Code permits the offer and sale of any contract under which the purchaser receives, within 28 calendar days from the payment of any portion of the purchase price, physical delivery of the total amount of the commodity to be purchased under the contract.

In the process of formulating its legislative proposal on leverage, the Commission also considered two alternatives to eliminating leverage transactions from regulation under the Act: retaining, and perhaps codifying, the existing moratoria; and lifting the moratoria, provided NFA or another registered futures association would share responsibility for regulating and policing an expanded leverage industry.

No Commissioner favored the alternative of retaining the existing statutory and regulatory scheme. However, should the Congress wish to do so, the Commission would respectfully request that the Congress, whether by statutory enactment or report language, support the Commission's existing moratoria provisions.

Two Commissioners favored an alternative plan under which the moratoria could be lifted gradually, provided the NFA or another registered futures association would share with the Commission the responsibility for regulating and policing an expanded leverage industry. However, before any modification of the moratoria could be made, substantial study of the impact upon and resource implications for both the Commission and NFA would need to occur.

In summary, because the Commission is concerned with the expansion of off-exchange instruments and the required commitment of resources which could otherwise be dedicated to overseeing the futures industry, the Commission recommends that leverage regulation be deleted from the Commodity Exchange Act. In any event, the Commission assures the Committee that these alternatives were thoroughly discussed and that the Commission will fully cooperate with whatever the Congress should decide on this matter.

C. Registered Futures Associations

1. Disciplinary Actions

The National Futures Association's disciplinary system for violations of its rules by members or their associated persons includes a summary procedure called a "member responsibility action" (MRA) which is used by NFA to obtain expeditious compliance with its rules and provide immediate protection to customers. The Commission generally regards the MRA as a powerful and appropriate tool for self-regulatory bodies such as the NFA to obtain immediate compliance. However, an impediment to the effective use of the MRA procedure -- and to NFA's disciplinary program as a whole -- results from the provisions of Section 17(h) of the Commodity Exchange Act.

Specifically, Section 17(h) presently provides that any person who is the subject of an NFA disciplinary action may appeal that action to the Commission with the effect of automatically staying the effectiveness of the NFA action. The Commission can lift the stay, but only after providing notice and opportunity for a hearing, which may consist of affidavits and oral argument. As a result, the effectiveness of NFA's MRA procedure -- which, by its very nature, is designed for use where immediate action is necessary to protect the markets, customers or other NFA members -- can be dramatically reduced. Similarly, the effectiveness of any sanctions imposed as a result of formal NFA disciplinary procedures are likely to be diminished if a suspended or expelled member can forestall the result merely by filing an appeal with the Commission.

The Commission, therefore, proposes to amend Section 17(h) to make the automatic stay provisions of that section inapplicable to NFA disciplinary actions, including member responsibility actions. This amendment would make the stay provisions of NFA's member responsibility actions parallel those for exchange disciplinary actions.

2. Commission Review of Association Action

Under the Commission's proposal, Sections 17(h) and 17(i) would be amended to make explicit that Commission review of NFA disciplinary actions is available only for final actions, precluding the disruption of the NFA disciplinary process by untimely appeals to the Commission and, ultimately, the courts. Further, we propose to amend Section 17(i) expressly to authorize the Commission to review only the record before NFA and the submissions of the parties. The actual standards for Commission review of any NFA decision would, however, remain essentially unchanged.

Finally, we propose to amend Section 17(i)(3), which deals with denial of membership in NFA or to association with an NFA member, to make the standards for Commission review of an NFA decision similar to those governing NFA disciplinary actions.

3. Rule Review Procedures

In order to facilitate the Commission's continuing oversight program of the National Futures Association and that group's implementation of key self-regulatory functions, the Commission is proposing legislative amendments designed to ensure that the Commission's oversight powers under the Act with respect to NFA parallel those for contract markets, the other self-regulatory organizations under the Commission's jurisdiction. Under the current law, the Commission's authority to alter or supplement the rules of the exchanges is significantly broader than its authority to change NFA rules.

Section 8a(7) of the Act permits the Commission to alter or supplement rules of the contract markets where such changes are "necessary or appropriate for the protection of persons producing, handling, processing, or consuming any commodity traded for future delivery on [a] contract market...or for the protection of traders or to insure fair dealing in commodities traded for future delivery on such contract market."

In contrast, Section 17(k)(2) authorizes Commission alteration and supplementation of NFA rules only where "necessary or appropriate in the public interest or to effectuate the purposes of this section [authorizing the establishment of registered futures organizations such as NFA]" with respect to three specified, largely procedural, areas:

> (A) the basis for, and procedure in connection with, the denial of membership or the barring from being associated with a member or the disciplining of members or persons associated with members, or the qualifications required for members or natural persons associated with members or any class thereof;

(B) the method of adoption of any change in or addition to the rules of the association; [and]

(C) the method of choosing officers and directors.

The difference in standards between the Commission's authority with respect to rules of NFA and the exchanges results in several anomalies. For instance, while the Commission is authorized to require alteration in an exchange's rules on minimum financial requirements for member futures commission merchants, the Commission apparently is not authorized to require such changes to be made in identical rules promulgated by NFA. Current statutory language also appears to exclude Commission alteration of NFA rules governing sales practices, despite the fact that NFA has primary responsibility for this area and is required by the Act to establish and implement a comprehensive sales practice program.

The Commission therefore proposes to amend Section 17(k) to make the Commission's authority to alter or supplement NFA rules parallel to, and no less broad than, the Commission's comparable authority with respect to the self-regulatory activities of the contract markets.

A similar, though less troubling, disparity is found in the statutory procedures concerning the Commission's authority to review and approve or disapprove new rules proposed by NFA and exchanges. While Section 17(j) of the Act requires that the Commission act on NFA rule proposals within 30 days unless a longer period is requested by either NFA or the Commission, no such limitation exists in Section 5a(12), which establishes rule review procedures with respect to the exchanges. In practice, the 30-day provision in Section 17(j) has not had a tangible impact on Commission review of NFA rules, and the difference appears to be purely technical.

A similar 30-day requirement formerly applied to the Commission's review of exchange rules under Section 5a(12) but was repealed in 1982 when Sections 5a(12) and 17(j) were substantially amended to establish the current, more streamlined rule review procedure. The legislative history of those amendments does not indicate any reasons why the otherwise parallel rule review procedures should differ in this relatively insignificant respect. The Commission therefore proposes that the NFA rule review process be made consistent with the similar provision governing other self-regulatory organizations.

D. Miscellaneous Amendments

1. Certain Prohibited Transactions

Section 9(d) of the Commodity Exchange Act makes it a felony for a Commissioner or Commission employee to participate, directly or indirectly, in commodity futures, option or leverage transactions or, with certain limited exceptions, in investment transactions in an actual commodity. In view of the vast increase in types of commodities on which futures contracts are now traded, the Commission is proposing changes to Section 9(d) to ease some of these restrictions. The amendments are designed to enable the Commission to administer Section 9(d) flexibly to assure that transactions that do not pose any conflict of interest concerns are not subject to the broad prohibitions contained in the present law. The proposed amendments should also obviate the need for the Commission to seek additional amendments to Section 9(d) in the future, as the commodity markets continue to expand into new areas.

Our proposed change to Section 9(d) would limit the restrictions on investment transactions in actual commodities to cover only those transactions which involve the use of nonpublic information or which are effected by means of a Commission-regulated instrument, such as a commodity futures or commodity option contract. Investment transactions in actual commodities permitted under existing law would continue to be permitted under the proposed amendments.

This proposal is consistent with Congressional revisions enacted in 1982. At that time Congress amended Section 9(d) to permit Commissioners and employees to invest in U.S. Government securities, certificates of deposit or similar financial instruments, so long as no nonpublic information is used and the transaction is not effected by an instrument regulated by the Commission. In the Commission's view, there is no reason why the philosophy underlying this 1982 amendment should not apply to investments in other commodities. So long as nonpublic information is not used and the commodity options or futures markets are not employed, the Commission believes the conflict of interest concerns underlying Section 9(d) are greatly diminished and its employees should be free to invest in actual commodities. Our proposal generally would permit these types of investments.

However, our proposal would prohibit investment transactions in actual commodities or instruments under other regulatory authorities that are specified by Commission rule. The Commission believes this provision is necessary in order for the Commission to adopt rules to avoid the appearance of conflicts of interest in certain instances. For example, various stock indexes are the subject of both futures contracts and options on futures contracts. Investment in these indexes would still be prohibited if effected through commodity futures and options contracts, since these are instruments regulated by the Commission. Some of these indexes, however, also underlie options traded on national securities exchanges. The Commission questions whether it would be appropriate to permit its employees to acquire an interest in these stock indexes by use of instruments which resemble Commission-regulated options.

The second change we propose would empower the Commission to develop appropriate exceptions to the absolute restrictions against participation in futures and options transactions. These exceptions, such as to permit modest holdings in large mutual funds that hedge their portfolios in the futures market, would be made only when the Commission determined that such investments would pose no conflict of interest concerns and otherwise would be consistent with Congressional intent in enacting Section 9(d). Of course, notwithstanding the adoption of any such exceptions that would permit Commission personnel to engage in such transactions, all Commissioners and employees would continue to remain subject to the criminal provisions of Section 9(e) of the Act, which bar Commissioners and employees from divulging to any market participant confidential information that may affect market prices.

2. Six-Year Reauthorization

Section 12(d) of the Commodity Exchange Act authorizes the appropriations of such sums as are required to carry out the provisions of the Act through the fiscal year ending September 30, 1986. We propose to extend the authorization for such appropriations for six years, until the fiscal year ending September 30, 1992.

The Commission has been fortunate to have the active interest and on-going oversight of this Congressional Subcommittee. We welcome your continued direction and oversight until our next reauthorization.

COMMODITY FUTURES TRADING COMMISSION
2033 K Street, N.W., Washington, D.C. 20581
(202) 254-6970

Susan M. Phillips
Chairman

January 24, 1986

The Honorable E de la Garza
Chairman
Committee on Agriculture
U.S. House of Representatives
1301 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

The Commodity Futures Trading Commission today is transmitting to the Speaker of the House a bill amending the Commodity Exchange Act, together with supporting documents, which would, among other things, reauthorize the Commission until September 30, 1992. The Commission also is making available separately, and only to the Committee, a document presenting the alternatives considered by the Commission to proposed Title II of the draft bill, which strikes Section 19 and other statutory references in the Act to the regulation of leverage transactions.

As you know, Mr. Chairman, the Congress in 1982 instructed the Commission to regulate the leverage industry. The Commission has put that regulatory scheme in place, and two firms currently are registered to operate under the Commission's regulatory program. A third firm has applied for registration and that application is pending. Separately, hearings on leverage regulation by the Subcommittee on Conservation, Credit and Rural Development last spring indicated an interest in reexamining the leverage issue within the context of expanding off-exchange activity and the Commission was invited to make a recommendation to the Committee in this area. In addition to the recommendation now being forwarded to the Congress, the Commission also considered two other alternatives for leverage regulation: (1) maintaining the current moratoria on new leverage entrants and products and (2) gradual lifting of the moratoria provided the National Futures Association assumes certain responsibilities for the regulation of leverage transactions. A majority of the Commission is recommending the elimination of leverage transaction regulation as a separate statutory category, since it views these transactions as indistinguishable from futures contracts, which under the Act, must be traded on exchanges, under the supervision of exchange self-regulatory organizations. Two Commissioners favored one of the above alternatives.

In view of the controversial history of the leverage issue, the Commission hopes that the enclosed appendix, which discusses alternatives to the Commission proposal as well as the explanation of the Commission's leverage proposal, will be helpful to the Committee as it considers this issue.

If I may provide any further assistance, please contact me. I look forward to working with you as the Committee considers the Commission's reauthorization.

Sincerely,

Susan M. Phillips

Susan M. Phillips
Chairman

Enclosures

APPENDIX

The Commission prefers the approach set forth in Title II of the bill. However, it did consider the following alternatives to eliminating leverage transactions from regulation under the Act,[1] the second of which was favored by two Commissioners.

1) Continuation of Moratoria

In keeping with the sense of Congress in 1982,[2] the Commission has repeatedly expressed the view that it will exercise caution in lifting the 1978 and 1979 moratoria in recognition of the historic difficulties associated with off-exchange transactions, the ever increasing demands on the Commission's limited resources and the lack of a self-regulatory organization for persons engaged in the leverage business.[3] The Commission has already assumed for purposes of budgetary planning that the regulatory moratoria will remain in effect for FY 1986 and FY 1987 and has so advised the Congress and the Office of Management and Budget.

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[1] The Commission also considered but did not adopt a proposal to eliminate dealer options from regulation under the Act. Advocates of this approach stated that leverage transactions and dealer options share the following characteristics: (1) both are analogous to futures contracts; (2) both are similar to exchange-traded instruments where there is a more competitive marketplace than exists for off-exchange instruments; (3) both are exceptions to the rule requiring exchange trading of futures and options; (4) both now operate under government-sanctioned monopolies; and (5) both lack commercial utility and are "sold" rather than "bought."

[2] *See* H.R. Rep. No. 964, 97th Cong., 2d Sess. 51 (1982); S. Rep. No. 384, 97th Cong., 2d Sess. 52 (1982); H.R. Rep. No. 565, Part 1, 97th Cong., 2d Sess. 109 (1982).

[3] *E.g.*, *Regulation of Trading of Leverage Contracts and Dealer Options: Hearings Before the Subcommittee on Conservation, Credit and Rural Development of the House of Representatives Committee on Agriculture*, 99th Cong., 1st Sess. 7, 9, 10, 11-12, 85, 86, 92, 103-104 (1985) (statement of Susan M. Phillips, Chairman, Commodity Futures Trading Commission).

Retaining the moratoria would provide the Commission with an opportunity to gain additional experience from temporarily regulating a limited number of leverage firms engaged in marketing leverage contracts involving a limited number of commodities. Such experience would better enable the Commission to determine whether trading in certain additional commodities pursuant to leverage contracts and/or by an expanded number of firms would be consistent with the public interest, and whether the Commission could ensure effectively the financial solvency of such transactions and prevent manipulation or fraud. In this way, the Commission would be able to determine most effectively if or when, and under what terms and conditions, to lift selectively the moratoria, subject of course to resource considerations.

Should the Congress wish to continue the present statutory and regulatory schemes for the foreseeable future, the Commission would endorse appropriate report language to support, or a statutory enactment to codify, the existing moratoria, with the Commission's retaining its existing discretion to determine when and how the moratoria should be lifted.

2) Lifting of the Moratoria with Participation of the National Futures Association

Should Congress believe that leverage transactions should be regulated under the Act and that the moratoria should be removed, the Commission would support Congressional direction that the moratoria be lifted by the Commission on a gradual, commodity-by-commodity and firm-by-firm basis, provided the NFA (or another registered futures association) share with the Commission the responsibility for regulating and policing an expanded leverage industry. The Commission points out, however, that before any modifications of the moratoria could be made, substantial study of the impact upon and resource implications for both the Commission and NFA would need to occur. In addition, prior to any such modifications, it would be appropriate for the Commission, in conjunction with NFA, to undertake to survey the commodities industry generally on the subject of leverage. In particular, such a survey could seek to measure the degree of industry support for or interest in a continuation or a lifting of the moratoria, including an evaluation of what other types of persons, whether currently regulated or unregulated, were interested in establishing a leverage business and what additional commodities, if any, should be permitted to become the subject of leverage transactions. Finally, a complete review of the existing regulations would have to be undertaken with a view to streamlining the regulatory program if there were to be an expanded leverage industry.

Under this approach, it would be appropriate for the Act to be amended so that, once the moratoria are modified or lifted, the Commission could require NFA, at a minimum, to perform those functions concerning all persons engaged in a leverage business that it currently performs concerning persons involved in a futures business, including registration, audit, disciplinary and other functions.

99TH CONGRESS
2D SESSION

H.R. ____________

A BILL

To extend the Commodity Exchange Act,
and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Futures Trading Act of 1986".

TITLE I - ENFORCEMENT; APPELLATE REVIEW

Fraudulent Practices

SEC. 101. Section 4b of the Commodity Exchange Act (7 U.S.C. 6b) is amended by striking out "on or subject to the rules of any contract market," after the words "any contract of sale of any commodity for future delivery, made, or to be made,".

Extraterritorial Service Of Subpenas

SEC. 102. Section 6(b) of the Commodity Exchange Act (7 U.S.C. 15) is amended by --

(1) inserting in the fourth sentence "or any foreign country or jurisdiction" after "United States or any State" and

(2) inserting immediately after the fourth sentence the following:

"A subpena issued under this section may be served upon any person who is not to be found within the territorial jurisdiction of any court of the United States in such manner as the Federal Rules of Civil Procedure prescribe for service of process in a foreign country.".

Court Of Appeals Review

SEC. 103. The Commodity Exchange Act is amended by adding after section 23 a new section 24 as follows:

"SEC. 24. Except where judicial review of Commission action is otherwise expressly provided for in this Act, any person adversely affected by a final order of the Commission or by any rule adopted by the Commission under this Act may obtain review of such order or such rule only in the United States Court of Appeals for the Circuit in which such person resides or has its principal place of business, by filing in such court within thirty days after notice of the order or the promulgation of such rule a written petition requesting that the order be modified or set aside in whole or in part or that the rule be set aside. A copy of such petition shall be forthwith transmitted by the clerk of the court to the Commission, and thereupon the Commission shall file in the court the record upon which the order complained of is entered, as provided in Section 2112 of Title 28, United States Code, or the rule under review, the Commission's rulemaking record, including all written submissions, the transcript of any oral presentations made during the course of the rulemaking, and any other materials prescribed by the court. No objection to the order or rule of the Commission shall be considered by the court unless such objection shall have been presented to and heard before the Commission. Upon the filing of the petition, the court shall have jurisdiction to affirm the issuance of the order or the adoption of the rule, or to set aside or modify the order or to set aside the rule. The findings of the Commission as to the facts, if supported by substantial evidence, shall be conclusive.".

Ex Parte Appointment Of Temporary Receivers

SEC. 104. Section 6c of the Commodity Exchange Act (7 U.S.C. 13a-1) is amended by inserting within the parenthetical phrase immediately before the close parenthesis in the first sentence ",and other than an order appointing a temporary receiver to administer such restraining orders and to perform such other duties as said court may deem appropriate".

TITLE II - LEVERAGE TRANSACTIONS

SEC. 201. Section 2(a)(1)(A) of the Commodity Exchange Act (7 U.S.C. 2) is amended by --

(1) striking out in the third sentence thereof ", and transactions subject to regulation by the Commission pursuant to Section 19 of this Act";

(2) inserting in the definition of "commodity trading advisor" in the fifteenth sentence thereof "or" after "made or to be made on or subject to the rules of a contract market," and

(3) striking out in the definition of "commodity trading advisor" in the fifteenth sentence thereof "or any leverage transaction authorized under Section 19,".

SEC. 202. Section 9(b) of the Commodity Exchange Act (7 U.S.C. 13(b)) is amended by --

(1) striking out in the first sentence thereof "," after "4h" and inserting in lieu thereof "or"; and

(2) striking out in the first sentence thereof ",or section 19".

SEC. 203. Section 9(d) of the Commodity Exchange Act (7 U.S.C. 13(d)) is amended by striking out in the first sentence thereof "or any transaction for the delivery of any commodity under a standardized contract commonly known to the trade as a margin account, margin contract, leverage account, or leverage contract, or under any contract, account, arrangement, scheme, or device that the Commission determines serves the same function or functions as such a standardized contract, or is marketed or managed in substantially the same manner as such a standardized contract,".

SEC. 204. Section 9(e) of the Commodity Exchange Act (7 U.S.C. 13(e)) is amended by striking out ", or in any transaction for the delivery of any commodity under a standardized contract commonly known to the trade as a margin account, margin contract, leverage account, or leverage contract, or under any contract, account, arrangement, scheme, or device that the Commission determines serves the same function or functions as such a standardized contract, or is marketed or managed in substantially the same manner as such a standardized contract" in each place such words appear therein.

SEC. 205. Section 12(e) of the Commodity Exchange Act (7 U.S.C. 16(e)) is amended by striking out in subsection (2) thereof "or 19".

SEC. 206. Section 19 of the Commodity Exchange Act (7 U.S.C. 23) is hereby repealed.

SEC. 207. Section 22(a) of the Commodity Exchange Act (7 U.S.C. 25(a)) is amended by --

(1) inserting after the semicolon at the end of subparagraph (1)(C)(i) thereof "or";

(2) striking out "(ii) a contract subject to section 19 of this Act; or"; and

(3) redesignating subparagraph (1)(C)(iii) thereof as subparagraph (1)(C)(ii) thereof.

TITLE III -- REGISTERED FUTURES ASSOCIATIONS

Disciplinary Actions

SEC. 301. Section 17(h) of the Commodity Exchange Act (7 U.S.C. 21(h)) is amended to read as follows:

"(h)(1) If any registered futures association takes any final disciplinary action against any member thereof or any person associated with such a member or denies admission to any person seeking membership therein, or bars any person from being associated with a member, the association shall promptly file notice thereof with the Commission. The notice shall be in such form and contain such information as the Commission, by rule, may prescribe as necessary or appropriate in furtherance of the purposes of this Act.

"(2) Any action with respect to which a registered futures association is required by paragraph (1) of this subsection to file notice shall be subject to review by the Commission, on its own motion, or upon application by any person aggrieved thereby filed within thirty days after the date such notice was filed with the Commission and received by such aggrieved person, or within such longer period as the Commission may determine. Application to the Commission for review, or the institution of review by the Commission on its own motion, shall not operate as a stay of such action unless the Commission otherwise orders, summarily or after notice and opportunity for hearing on the question of a stay (which hearing may consist solely of the submission of affidavits or presentation of oral arguments). The Commission shall establish for appropriate cases an expedited procedure for consideration and determination of the question of a stay."

Commission Review of Association Action

SEC. 302. Section 17(i) of the Commodity Exchange Act (7 U.S.C. 21(i)) is amended to read as follows:

"(i)(1) In a proceeding to review a final disciplinary action taken by a registered futures association against a member thereof or a person associated with a member, after appropriate notice and opportunity for hearing (which hearing may consist solely of consideration of the record before the association and opportunity for the presentation of supporting reasons to affirm, modify, or set aside the sanction) --

"(A) if the Commission finds that such member or person associated with a member has engaged in such acts or practices, or has omitted such acts, as the association has found him to have engaged in or omitted, and that such acts or practices, or omissions to act, are in violation of the rules of the association as have been specified in the determination of the association, and that such provisions are, and were applied in a manner, consistent with the purposes of this Act, the Commission, by order, shall so declare and, as appropriate, affirm the sanction imposed by the association, modify the sanction in accordance with paragraph (2) of this subsection or remand to the association for further proceedings; or

"(B) if the Commission does not make any such finding it shall, by order, set aside the sanction imposed by the association and, if appropriate, remand to the association for further proceedings.

"(2) If, after a proceeding in accordance with paragraph (1) of this subsection, the Commission finds that any penalty imposed upon a member or person associated with a member is excessive or oppressive, having due regard to the public interest, the Commission shall by order cancel, reduce, or require the remission of such penalty.

"(3) In any proceeding to review the denial of membership in a registered futures association or the barring of any person from being associated with a member, if the Commission, after appropriate notice and hearing (which hearing may consist solely of consideration of the record before the association and opportunity for the presentation of supporting reasons to affirm, modify, or set aside the sanction), determines that the specific grounds on which such denial or bar is based exist in fact, that such denial or bar is in accordance with the rules of the association, and that such rules are, and were applied in a manner, consistent with the purposes of this Act, the Commission shall by order dismiss the proceeding; otherwise, the Commission shall by order set aside the action of the association and require it to admit the applicant to membership therein, or to permit such person to be associated with a member.

"(4) Any person (other than a registered futures association) aggrieved by a final order of the Commission entered under the provisions of this subsection may file a petition for review with a United States court of appeals in accordance with section 6(b) of this Act."

Rule Review Procedures

SEC. 303. Section 17(j) of the Commodity Exchange Act (7 U.S.C. 21(j)) is amended by striking out the third sentence thereof.

Alteration or Supplementation of Association Rules

SEC. 304. Section 17(k) of the Commodity Exchange Act (7 U.S.C. 21(k)) is amended by --

(1) striking out "title" in subsection (1) thereof and inserting in lieu thereof "section"; and

(2) amending subsection (2) thereof to read as follows:

"(2) The Commission may in writing request any registered futures association to adopt any specified alteration or supplement to its rules with respect to any of the matters hereinafter enumerated. If such association fails to adopt such alteration or supplement within a reasonable time, the Commission is authorized by order to alter or supplement the rules of such association in the manner theretofore requested, or with such modification of such alteration or supplement as it deems necessary if, after appropriate notice and opportunity for hearing, it appears to the Commission that such alteration or supplement is necessary or appropriate in the public interest to assure fair dealing by the members of such association, to assure a fair representation of its members in the administration of its affairs, or to effectuate the purposes of this section. Such alterations or supplements may specify changes with respect to such matters as --

"(A) the basis for, and procedure in connection with, the denial of membership or the barring from being associated with a member or the disciplining of members or persons associated with members, or the qualifications required for members or natural persons associated with members or any class thereof;

"(B) the method of adoption of any change in or addition to the rules of the association;

"(C) the method of choosing officers and directors;

"(D) safeguards with respect to the financial responsibility of members;

"(E) the manner, method, and place of soliciting business by members, including the content of such solicitations; and

"(F) the form and manner of handling, recording, and accounting for customers' orders, transactions, and accounts by members."

TITLE IV - MISCELLANEOUS AMENDMENTS

Certain Prohibited Transactions

SEC. 401. Section 9(d) of the Commodity Exchange Act (7 U.S.C. 13(d)) is amended by--

(1) inserting before the period at the end of the first sentence "if nonpublic information is used in such investment transaction, if such investment transaction is prohibited by rule or regulation of the Commission or if such investment transaction is effected by means of any instrument regulated by the Commission: Provided, That the foregoing prohibitions shall not apply to any transaction or class thereof that the Commission, by rule or regulation, has determined would not be contrary to the public interest or otherwise inconsistent with the purposes of this section" and

(2) striking out the second and third sentences thereof.

Reauthorization

SEC. 402. Section 12(d) of the Commodity Exchange Act (7 U.S.C. 16(d)) is amended to read as follows:

"(d) There are hereby authorized to be appropriated to carry out the provisions of this Act such sums as may be required for each of the fiscal years during the period beginning October 1, 1986, and ending September 30, 1992.".

TESTIMONY OF ROBERT K. WILMOUTH
PRESIDENT

NATIONAL FUTURES ASSOCIATION

Mr. Chairman, Members of the Committee --

I am Robert K. Wilmouth, President of National Futures Association, the nationwide self-regulatory organization for the futures industry. Four years ago I appeared before you in a very different capacity with no idea that I would shortly be called to help build NFA into a powerful regulatory force for the protection of futures customers. Nevertheless, I joined my voice with many others in making a promise for NFA. As president of the oldest self-regulator in the futures industry I was confident of the industry's resolve to continue to deliver effective and efficient self-regulation. Four years ago that promise was articulated for the entire futures industry by Leo Melamed, NFA's founder and Chairman, when he said "We are prepared, willing and capable of sharing the regulatory burden and costs . . . *if given a chance*."*

You gave us that chance. NFA exists today because you believed in the premise of self-regulation and the promise of NFA. But you also wisely required accountability by setting ambitious performance goals for NFA and by requiring a report on NFA's first three years. I am pleased to say that the CFTC's report concludes that NFA has met those goals. NFA has also prepared a report entitled The First Three Years which has been separately supplied to the members of the Committee and staff. I come before you today to highlight NFA's Report and demonstrate that NFA is a promise fulfilled.

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* Hearings on H.R. 5447 Before the Subcommittee on Conservation, Credit and Rural Development of the Committee on Agriculture, House of Representatives, 97th Cong., 2d Sess. 209 (1982) (Statement of Leo Melamed).

- NFA fulfilled its promise to relieve the CFTC of the burdens and costs of direct regulation facilitating the allocation of its resources in areas essential and appropriate for continued industry growth and to assure industry accountability. In its first three years NFA has spent more than $37 million in its operations. Even subtracting the cost of CFTC oversight and the amount of fees the CFTC might have collected over that time, NFA's net contribution toward federal government savings exceeds $35 million. Because of NFA, the CFTC no longer routinely performs financial or sales practice audits. Instead, NFA has performed nearly one thousand on-site financial, operational and sales practice audits and examinations saving the CFTC the 105 staff positions each year that would be needed by the CFTC to accomplish the same result.

- NFA fulfilled its promise to fill the gap where no self-regulator or government agency previously had a real presence. NFA has had a tremendous regulatory impact on non-exchange member futures professionals, increasing voluntary compliance through patient auditing, counseling and educational efforts. Although the CFTC had only been able to audit sporadically in this area, NFA has provided a guiding hand to many professionals who had never before had contact with any regulator.

- But NFA also fulfilled its promise to apply a firm hand where needed. NFA's investigative program detects and exposes violations of NFA Requirements requiring disciplinary measures or immediate remedial action. NFA's Business Conduct Committees have issued numerous Complaints against Member firms. These have resulted in various penalties including stiff fines and, in 8 cases, expulsion from NFA which means exclusion from the futures business. In addition to the disciplinary procedure, NFA has also used its power to immediately remedy a danger to customers through a Member Responsibility Action. An MRA is designed to eliminate a threat by, for example, barring a Member from taking on any new business, or, in appropriate cases, by suspending its membership which, like expulsion, terminates the Member's right to conduct any futures business. NFA took 78 such actions in its first three years which demonstrates our resolve to act quickly and forcefully where necessary.

- NFA fulfilled its promise to extend the battle against unethical practices beyond the bounds of the legitimate futures industry. NFA and the CFTC pooled their resources and expertise to help the North American Securities Administrators Association draft a Model State Commodity Code to allow the states to put flesh on the bones of the "open season" provision which you enacted in 1982. This will empower state regulators to stand, as you intended, shoulder-to-shoulder with the CFTC and NFA in the effort to eliminate regulatory safe havens for the unscrupulous. NFA has also worked hard to provide referrals and expert assistance to state and federal regulators and prosecutors. NFA has initiated an investor education program supported by a network of organizations committed to consumer protection. For example, with the cooperation of the CFTC, 120,000 copies of NFA's investor awareness publication have been distributed by the Consumer Information Center during the past seven months.

- NFA fulfilled its promise to promote compliance with high levels of ethical standards in the industry. Through tough new rules and guidelines relating to discretionary accounts, advertising and fee disclosure as well as NFA's "Know Your Customer" Rule, NFA has made giant strides toward refining the standards of ethical business conduct. These rules and guidelines carry the special force which comes from industry consensus after extensive and searching analysis and discussion by actual practitioners serving on NFA's Advisory Committees and governing bodies. In addition, other standards have evolved from the decisions of NFA's Business Conduct Committees.

Here again the standards are more compelling because they are determined by practitioners exercising their impartial but informed judgment in actual cases.

- NFA fulfilled its promise to raise the standards of knowledge and proficiency in the futures industry by establishing a uniform industry-wide testing requirement for all new associated persons and a two-year experience requirement for brokerage APs who manage discretionary accounts.

- NFA fulfilled its promise to take over the arduous registration tasks. Not only is NFA now doing virtually everything in the registration area that the CFTC did prior to October 1, 1982, but NFA is also registering IBs, the fastest growing category of registrant, and issuing temporary licenses to all eligible associated persons -- two functions established by the 1982 legislation which the CFTC was never required to perform using its own resources. NFA has devoted over 50 staff people to the task of dealing with over 60,000 active files. NFA continues to use the flexibility available in the private sector to make registration an efficient and effective regulatory tool.

- NFA fulfilled its promise to avoid becoming a duplicative regulatory layer by working closely with the futures exchanges not only to avoid regulatory overlap but also to harmonize existing compliance requirements and establish a single coherent set of high standards for the entire futures industry.

- NFA fulfilled its promise to provide a fast, fair system to resolve customer claims against futures professionals. With over 1,000 volunteer arbitrators from 47 states, NFA's arbitration program provides fair and impartial arbitration hearings virtually anywhere in the U.S. in an average of less than seven months. These benefits have been recognized, and already NFA's arbitration program is selected by many customer claimants. Needless to say, that has substantially reduced the pressure on the CFTC's reparations program and, along with improvements made by the CFTC, has made reparations run more smoothly.

- NFA fulfilled its promise to be efficient. For example, NFA reduced the number of separate registration forms and fees many brokerage employees were required to file from as many as five down to one. Also, NFA audits are thorough but efficient. The arbitration program, as I said, handles as many filings now as CFTC reparations with a paid full-time staff of four. Finally, NFA uses its state-of-the-art in-house data processing capabilities to speed registration and to automate complicated financial analysis and other surveillance functions which would otherwise occupy many staff hours in laborious manual tasks.

- Also, and I think this is particularly important, NFA fulfilled its promise to avail itself of the best and the brightest talents both from within and without the futures industry. Of the more than 300 employees on our staff today, many have valuable prior experience with brokerage firms, exchanges, public accounting firms, the CFTC and other industry-related organizations. All Compliance personnel undergo an intensive training program in order to be skilled in audit techniques and prepared to execute the compliance programs that NFA has established for its Members. NFA's Legal Department consists of nine attorneys including a senior staff of experienced trial lawyers. In fact, one senior attorney teaches a trial practice course at Loyola University School of Law. NFA's Information Center which fields telephone inquiries is staffed with highly trained and motivated individuals selected for their ability and willingness to serve others. The Registration staff includes people with broad experience with the CFTC and exchange registration programs as well as people with extensive data processing expertise. NFA's Information Systems Department itself is staffed with highly qualified data processing experts, many of whom were intimately involved with designing our basic systems. NFA's Treasurer's office, staffed with a number of CPAs, has established stringent controls over NFA's income, investments and expenditures.

But the staff is only part of the story. Enormously valuable talents and expertise are donated by members of NFA's

Advisory Committees, Business Conduct Committees, governing bodies and arbitration panels. Individuals such as former CFTC commissioners, current and former exchange chairmen and presidents, brokerage firm chief executive officers, former CFTC staff, former exchange compliance personnel, floor traders and other experts in the futures industry have donated an estimated 8,000 hours of valuable time.

Finally, and perhaps most importantly, NFA fulfilled its promise to achieve its ambitious goals _without spending a single penny of taxpayer money_. As an entirely self-financed body, NFA has demonstrated the continued willingness of the futures industry to bear its fair share of the cost of regulation.

Those, in a nutshell, are NFA's accomplishments which, as I said, are described in more detail in NFA's full Three-Year Report. As an organization which has fulfilled its promise, done its job and assumed an important place in the structure of regulation, NFA would now like briefly to offer its views on the CFTC's legislative proposals which impact NFA.

NFA strongly supports two of these proposals. Section 17(h) of the Act now automatically stays an NFA disciplinary action when a Member appeals to the Commission. This provision unintentionally undercuts NFA's authority to protect customers in emergency situations. As the Commission has noted, one of NFA's most effective tools in dealing with such situations is the Member Responsibility Action. MRAs allow NFA to take immediate action to restrict a Member's operations when necessary to protect customers. However, under current law the target of an MRA can nullify its protective effect merely by filing a piece of paper without making any showing whatsoever. The Commission's proposed amendment to Section 17(h) would remedy this situation by making a stay of the action discretionary. NFA wholeheartedly supports this approach.

NFA also favors the proposed amendment to Section 17(i) which offers certain refinements to the process of reviewing NFA actions. We only note that this Section should continue to have the flexibility to be used to review MRAs where the immediate issue is not necessarily the violation of a rule but rather a danger to customers.

NFA must strongly disagree, however, with the Commission's proposed amendment to Section 17(k)(2) of the Act which would give the Commission virtually complete authority to alter or supplement and in essence to write NFA rules. Based on NFA's performance during its first three years, this proposal seems both unnecessary and unwise.

One simple question comes to mind: why now? In 1974, and again in 1978 and still again in 1982, Congress closely examined the role of the as-yet-untested NFA. On none of these occasions did the Congress or the CFTC see a need for the power the CFTC now seeks. You would assume that the power to rewrite NFA's rules would now be sought only if actual experience had shown that NFA had come up short in tackling tough issues. The facts are precisely the opposite. Consider the record:

- On a "Know Your Customer" Rule for the futures industry NFA acted;

- On acceptable content for advertising materials and telephone solicitations NFA acted;

- On proficiency testing for applicants for AP registration NFA acted;

- On disclosure of fees by all NFA Members, on an experience requirement for discretionary trading, on more stringent supervisory requirements, on all of these and other issues as well, NFA acted.

The key to NFA's success in dealing with these difficult issues which had been unresolved for so long has been the unwavering support of the rule development process by NFA Members. Each rule considered by NFA is closely scrutinized, dissected, redrafted and refined by one or more committees of Members, in light of general Member comment, over a period of months before being considered by NFA's Executive Committee and Board of Directors. The end result of the process reflects the expertise and judgment of the scores of individuals who have been involved and the countless hours of careful consideration given each proposal. That sort of intense and dedicated involvement in the rule development process is essential if NFA is to continue to lead the way in the development of customer protection rules for the futures industry.

But the CFTC's proposal threatens NFA's ability to do just that. Under current law, the Commission must approve NFA Rules which are consistent with the requirements of the Act. Within that standard NFA has the freedom to exercise its informed judgment. That freedom would be limited, however, if the Commission could substitute its judgment for NFA's by merely threatening to use its "amendatory veto." There is no incentive to even discuss solutions to tough ethical problems where there is a real possibility that the solution will be freely rewritten. The only incentive the CFTC proposal offers is to let sleeping dogs lie. The current proposal rewards the exemplary performance of NFA's Members by undercutting their authority; by substituting government regulation for self regulation; by transforming a cooperative process with proven advantages into an adversarial one with proven disadvantages; by threatening to make NFA no more than the CFTC's Division of Self-Regulation. In short, this proposal simply does not make sense.

What is perhaps most puzzling about this proposal is why the Commission thinks it is necessary. None of its explanations hold water.

First, the Commission argues that because it has broader authority to alter the rules of the exchanges it needs such authority over NFA. Such an argument places symmetry above substance. NFA is not a contract market. Its interests are different. Its level of congressional guidance is different.

Second, the Commission claims that certain "anomalies" result from its lack of authority to rewrite NFA rules. These are really "mirages" -- perceived problems which do not exist. The Commission's complaint that it is powerless to require NFA to alter its financial requirements is simply wrong. Congress took care of that. Section 17(p)(1) of the Act explicitly requires NFA to adopt and enforce financial requirements which are at least as stringent as those imposed by the CFTC. The Commission already has the authority to alter NFA's financial requirements merely by altering its own. The "anomaly" resulting from the Commission's inability to rewrite NFA sales practice rules is another mirage. Congress used its authority to direct NFA to develop sales practice standards by adopting Section 17(p)(3) in 1982 and NFA responded. Arguably NFA has been more agressive in developing requirements like the "Know Your Customer" Rule than the Commission itself. Furthermore, if the Commission feels that the industry wide ethical guidelines developed by NFA are inadequate, it already has the authority to correct any perceived shortcomings through its own rule making process. This is a far more appropriate means of dealing with such issues than the authority it now seeks.

The fact that its authority to alter exchange rules has been used so infrequently, and never to make the types of changes listed in the proposed amendment, is further proof that the CFTC does not need the power it now seeks. The very existence of such power, however, may dull the aggressive approach to the rulemaking process which NFA Members have taken.

In sum, this proposal does not merely try to fix something which is not broken -- it threatens to break something that is working extraordinarily well.

Finally, the Commission proposes to amend Section 17(j) to delete the requirement that the Commission act on

NFA rule proposals within thirty days unless a longer period is requested. NFA believes that whatever minimal incentive the current statute provides for a timely consideration of NFA rule proposals, should not be eliminated.

In conclusion, for the fourth time in twelve years you are taking a close look at the structure of futures regulation. On each prior occasion you have made one consistent point -- you wanted NFA. NFA was only an idea in 1974 which Congress brought into sharper focus in 1978. By 1982 NFA was not only a goal of the Congress but a promise from the futures industry. We asked for the chance to regulate ourselves and you gave us that chance. We think we have made good our opportunity, that we have met and even, perhaps, exceeded your hopes and expectations -- that we have fulfilled the promise. But we believe self-regulation holds still greater promise and we look forward to continuing to strive for its fulfillment.

cm(D17/F3)

STATEMENT OF JOHN F. SANDNER, CHAIRMAN, CHICAGO MERCANTILE EXCHANGE

Mr. Chairman, members of Congress, ladies and gentlemen,

My name is John F. Sandner. I am accompanied by Leo Melamed, the Chairman of our Executive Committee, and William J. Brodsky, our President. I am currently serving as Chairman of the Board of Governors of the Chicago Mercantile Exchange. I have previously served three terms as chairman of the Exchange. I have also headed the CME's business conduct, probable cause and commodity representative/customer complaint committees. Apart from my duties to the Exchange, I am president of Rufenacht, Bromagen & Hertz, Inc. (RB&H), one of the major agricultural futures commission merchants ("FCMs"). In addition, I have been an active floor trader for fourteen years.

Over the past 15 years, our Exchange and the U.S. futures industry have been among the world's most successful businesses. During that time, CME annual volume rose from 3.3 million contracts (1970) to 56.5 million (1985), an increase of 1605%.

Moreover, we have been innovators and catalysts producing new market tools and spearheading the charge toward internationalization. Approximately one-third of our business flows from foreign lands bringing to the United States approximately $1 billion of margin deposits each day.

Our volume has soared; our futures and options markets have grown to provide risk management tools to all sectors of agriculture and finance; our importance and critical role in the world's economic structure has been confirmed by the Federal Reserve Board and other federal agencies. Indeed, America's futures and options markets are the envy of and model for every financial center worldwide.

My many years of participation in the futures industry have provided me with valuable personal experience in every aspect of this industry. I know the needs of public customers and share their demand for fair, fast and efficient execution of orders. I place orders for my own account and I answer to the customers of my firm when they are dissatisfied. I know the needs of hedgers for relief from outmoded definitions and the need of speculators for relief from restrictive speculative limits that impair liquidity and stifle hedgers. On the other side, my work with the CME's committees and the Exchange's compliance and enforcement staff has brought the problems associated with the prevention, detection and prosecution of abusive practices into sharp focus. The leaders of the Chicago Mercantile Exchange know what is necessary to improve our current high level of performance. Moreover, we voluntarily took the initiative in the drive to computerizing trade surveillance. Indeed, we are nearing completion of the third stage in our own highly sophisticated program to analyze, deter and prove trading infractions.

AUDIT TRAIL

Let me first address the so called "audit trail" issue. So called because "audit trail" per se is not an issue. The exchange agrees that its "audit trails" can and should be enhanced. The real issue is the CFTC's regulation requiring manually entered trade times. The proposed rule was published for public comment in January 1985. This exchange and others within the industry worked diligently to prepare responsible comments providing the CFTC with a means by which they could accomplish their goal without impairing the lifeblood of futures trading -- contract liquidity.

One year later and without additional consultation with the industry, the Commission approved final rules calling for one-minute time sequencing of all transactions. On its face, the requirement was inflexible, unnecessarily harsh and, if implemented, would have been destructive to our marketplace.

Needless to say, the Commission's action raised angry cries throughout the industry -- including customers who understood the impact of the rule on the liquidity of markets and on the costs of order execution and delayed reports of execution. It appeared as if the Commission were willing to cripple an industry because a small number of investigations of alleged abuses produced ambiguous conclusions.

The cry has lead to an extremely constructive dialogue. As a result, we ascertained the correct interpretation of the CFTC's audit trail demands. It now appears that the CME and CBOT's discussions with the CFTC are leading to standards for a flexible and workable audit trail. Chairman Phillips recently advised us that the narrow wording of Regulation §1.35 will not control its application and has suggested that the purpose of Regulation §1.35 was to create an effective audit trail and that its one-minute timing standard was not controlling.

Rather, it seems, our goals are identical -- to enhance the audit trail -- to computerize the audit trail -- to deter, detect and punish rule violations -- but to allow our markets to continue to grow -- to allow our markets to draw foreign investments to U.S. banks -- to allow our markets to employ thousands of people -- to allow our markets to perform their congressionally mandated function -- to allow for the efficient hedging by our agriculture producers and the fair and efficient discovery of prices in the agricultural sector.

Thus, response to the CFTC's call for an enhanced audit trail and after several exhaustive months of work we, in liaison with the Chicago Board of Trade, developed a surveillance system -- which we have named "CTR"

(Computerized Trade Reconstruction) — which will accomplish our mutual goals by assigning transaction times to every public order and sequencing each trader's personal trades. CTR will give us sufficient detail to detect and prevent abusive trade practices and manipulations.

If I may, I'd like to quote a portions of the preamble to CTR:

> "The primary goal of CTR is to provide an accurate, effective audit trail. CTR achieves this result by identifying a computer generated transaction time for every trade.... CTR will be an overall deterrent to trade violations and abuses. CTR either reliably captures the time of the transaction or its position among the trades of a local. The instances when the time is not correctly calculated are few and cannot be anticipated. Because the failures are infrequent and unpredictable, no broker or local can rely on a flaw in the system in order to plan a rule violation."

Mr. Chairman, we are ready to spend the money necessary to write and debug the computer programs. We are ready to direct our members to invest in the hardware and personnel necessary to make the system work. We are ready to train employees to use the information. We are ready to buy the terminals so the information can be used by these trained employees. All we require is a signal to proceed and confidence that our reliance on the Commission's interpretation of the language of the regulation will protect us from law suits and compliance actions after memories have faded.

RULE-MAKING/CAPITAL RULES

The second issue I'd like to address involves the new CFTC proposed capital requirements for futures commission merchants.

The catalyst for the CFTC's captial rule proposal was the failure of Volume Investors, a clearing member of the Commodity Exchange (COMEX) of New York. While the CFTC's investigation indicated that Volume's failure was the result of rule violations rather than a sign of inadequate industry capital rules, the Commission nevertheless promulgated a new capital rule for the entire industry. The CFTC allowed an apparent exception to become cause for a general requirement. In doing so, the CFTC acted without a sufficient study, without sufficient calculations, and without consultation or assistance from private sector experts.

The resulting proposed rule is so harsh that it would close a substantial number of our solvent, safe and established clearing firms that have had an impeccable history in dealing with the public. If this proposed rule became effective, it would serve to disenfranchise many within our FCM community for no reason other than that one firm violated existing regulations. This is a clear example of CFTC rule-making inadequacies from which our industry must be protected. Mr. Chairman, we agree that our capital rule should be reviewed from time to time and strengthened whenever necessary, but with care and forethought.

Accordingly, the CME and the CBT will make a legislative proposal to improve the CFTC's rule-making process by invoking proper restraints and safeguards so that our industry can be protected from careless, sweeping actions which materially affect our viability.

OPTIONS PILOT PROGRAM

Financial Options

We are seriously concerned with the CFTC's continuing policy of restricting the number of option contracts that may be traded on each futures exchange. As you know, the CFTC permitted options trading on financial instruments under a three-year pilot program scheduled to end October 1, 1985.

The program includes restrictions on sales practices and severe limitations on the number of contracts that can be traded at each exchange. We were permitted at first, to trade two options contracts — due to market factors and competitive pressures we chose an option on the S&P 500 Index, which was approved in January 1983, and Deutsch marks, approved one year later in January 1984; then an additional three -- Eurodollar, Swiss franc, British pounds, approved yet another year later in February 1985; and lastly, another three, only one of which, the Japanese yen, was approved in March 1986, again a year had elapsed. In addition to the delays suffered due to the absolute limits on the number of available option contracts, we have been injured by the Commission's dilatory processing of option contract applications. An option contract based on an existing currency futures contract raises no genuine issue for Commission concern.

Although the pilot program should have ended, it did not. Instead, the CFTC chose to extend its "pilot" status. As a direct consequence, it has given our competitors, the Philadelphia Stock Exchange and Chicago Board Options Exchange -- which are not subject to artificial limitations -- a distinct competitive advantage. The SEC wisely permitted their markets to quickly begin trading options on foreign currencies which are virtually identical to those which we, the CME, pioneered fourteen years ago but, from which we were excluded by our federal regulator. Futures markets were left at the gate petitioning the CFTC to lift the limits on the number of contracts that they could trade and allow them to file applications for similar contract designation. Although the CFTC eventually responded to these petitions (on an ad hoc basis), the delay injured our competitive posture. The Commission ought to be flexible enough to rapidly process and approve "clone" contracts rather than allowing the securities exchanges an uncontested market.

AGRICULTURAL OPTIONS

The CFTC's more stringent limitations on agricultural options result in a hardship for the entire American agricultural community.

As you know, Mr. Chairman, our farm sector has been hard-hit and the prospects for its recovery are far from bright. The new farm bill has placed a great emphasis on the free market in the hope that farmers will ultimately become less dependent upon government assistance. If this policy is to work, farmers must be funded by the private sector. If this is to happen, the credit institutions must be able to guage and control the farmer's price risks. In order to guage and control the risk, farmers and bankers must understand and learn to rely upon free market tools and must be given access to every marketing technique available.

Unfortunately, the CFTC's limitation on the number of option contracts denies American farmers an efficient instrument of price insurance on several agricultural commodities. CFTC policy denies our farmers a hedging tool which can protect them against falling prices and allow them the benefit of gain. It is contrary to the best interests of the farm community. Please note that the National Cattlemen's Association in January resolved to urge us to open a feeder cattle option contract. In addition, the National Cattlemen's Association plans to request that the CFTC expand the option pilot program to five agricultural options. At this time, the CME is trading our limit, hog and cattle options. Clearly then, this Committee ought not countenance the restrictive CFTC options policy. We understand that the Commission may consider increasing the number of agriculture options permitted each exchange at an open meeting scheduled on March 25. We urge the Commission to remove all artificial restraints on the agricultural sector.

A tangential issue is the CFTC's overstepping its authority with respect to the margining system governing options. We will reserve our complaints at this time because we are hopeful that the Commission will eventually agree with our view and allow the exchanges to resume option margin authority, as Congress intended.

DOUBLE JEOPARDY

Next is an issue relating to the CFTC's misuse of its powers to investigate and prosecute rule violations which have been or are being attended to by the exchanges. In 1982, during reauthorization hearings, we called to your attention the Commission's practice of investigating and re-prosecuting individuals who had already been punished by an exchange. The CFTC promised that it would exercise its discretion and Congress thus gave it four more years.

The record of the CFTC during that period has not been good. The CFTC regularly duplicates investigations and re-prosecutes without first determining whether the penalty meted out by an exchange was adequate. This is wasteful.

We believe that the CFTC has failed the Congressional test in this area and its discretion ought to be restricted.

HEDGING

Suffice it to say that while the industry has grown ten fold, while the economy has changed dramatically and while innovation in the transfer of risk has been extraordinary, the CFTC's archaic definition of hedging has not changed. The CFTC has not followed the Congressional direction to bring the definition of hedging into line with realities of today's financial markets.

The Commodity Exchange Authority mandated speculative position limits in the grains in the 1940's, and exchanges have established speculative position limits in other agricultural markets where limits are appropriate. In 1981, the Commission promulgated Regulation §1.61 which required exchanges to establish speculative positon limits in all markets, including the financial markets. The distortions this regulation has caused are at the root of the need for a broader definition of hedging.

We strongly opposed Regulation §1.61 at the time it was implemented, and we continue to believe that this regulation hampers the efficient functioning of these markets without providing any material benefits. For example, I would challenge anyone to justify speculative position limits in our currency markets. It is absurd to contemplate someone cornering the market for Deutsch marks, for example. And even if this were possible, it would not be done in the futures market, which accounts for only a minor part of all Deutsche mark trading.

The existence of this regulation also needlessly alters the competitive landscape. The Chicago Board Options Exchange and the Philadelphia Stock Excahnge both have competing currency option trading programs. However, each has speculative position limits of 25,000 CME-size contracts while our Exchange is saddled with a limit of 6,000 contracts.

We don't believe that speculative limits make sense in financial markets. We believe that if the Commission were required to carefully examine the issue it would eliminate these rules. Elimination of position limits in financial markets in turn, will, do much to ease the problems stemming from the inadequate hedging definition.

CONTRACT DESIGNATION

We would also be remiss not to bring to your attention the fact that the CFTC has continued to be excessively slow in processing applications for new contracts. Our initiatives are halted while our SEC-regulated competitors receive quick approval and capture our potential market share.

Mr. Chairman, timing is important. In some circumstances, the threat of delay has been used to force concessions from the Exchange. This practice must cease.

NFA

We also wish to offer an opinion that the CFTC's demand for additional rule-making authority over the National Futures Association (NFA) is totally unnecessary. The NFA has been a model self-regulatory institution which has received high commendation from the CFTC itself. There is, therefore, no compelling reason to grant the CFTC the additional authority it seeks.

JUDICIAL REVIEW

The CFTC has proposed legislation which is intended to further insulate its rule making and decisional process from scrutiny by restricting judicial review to the Courts of Appeals. It appears that the Commission hopes to avoid the very limited discovery that might be allowed in the District Court. Thus, the record made by the Commission from which process the exchanges are effectively excluded will be the sole basis for decisions in the courts. Given the record of this agency, this is not a rational choice. The record suggests that the Commission's judgements should be subjected to deeper inquiries and more demanding standards -- not more superficial and less demanding.

PERIOD OF REAUTHORIZATION

Our concerns with the CFTC's rule making processes compel our opposition to its request for a six year reauthorization cycle. That is too long a period of time for this agency to go without congressional scrutiny. Where Congress' mandate does not appear to have been the guiding force behind an agency's actions and decisions for the prior four years it is not appropriate to demand six years of freedom from review. Indeed, the CFTC's actions during the last 15 months would suggest a more timely review than four years.

LEVERAGE

We support Congressman Dan Glickman's position an an effective way to resolve the leverage issue.

CONCLUSION

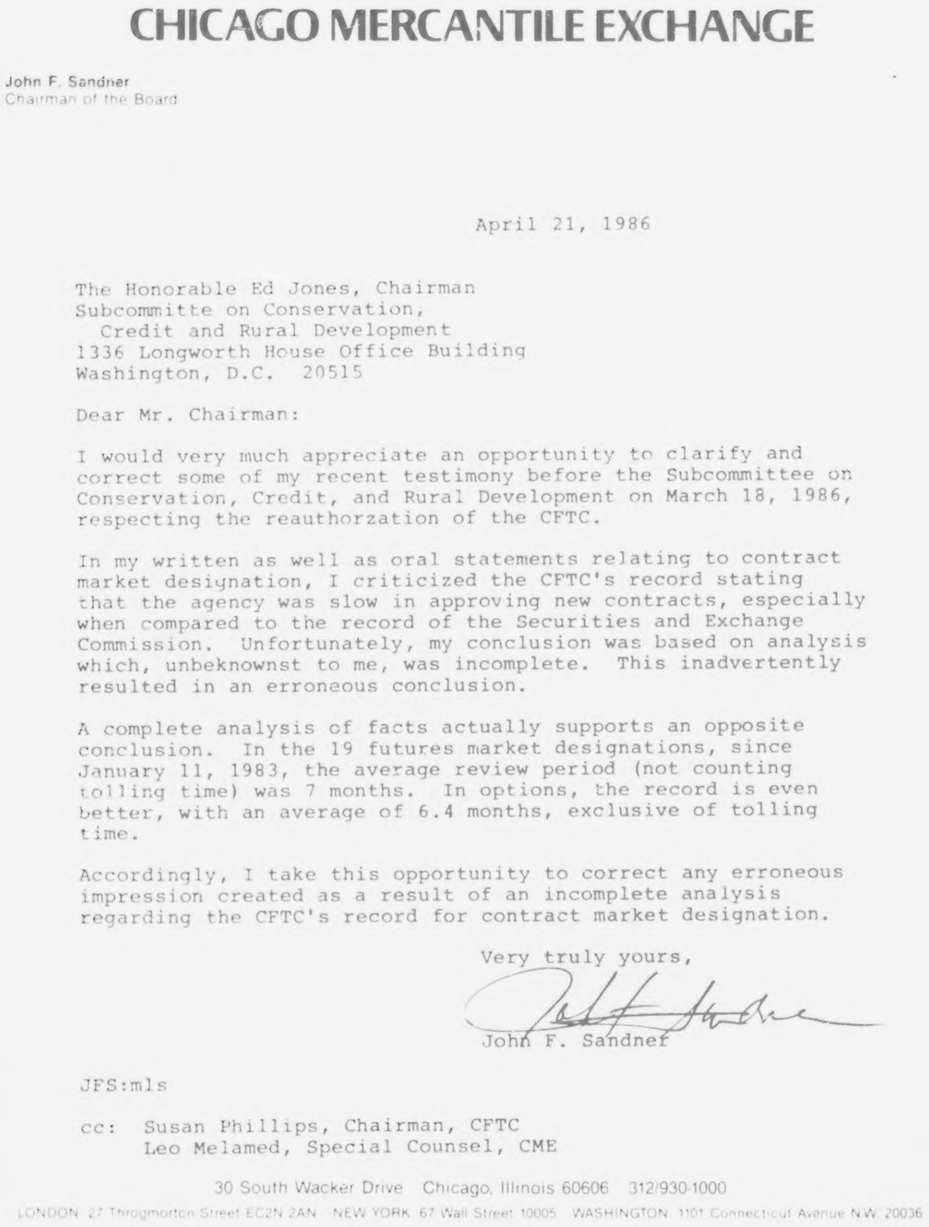
In conclusion, Mr. Chairman, allow me to go back to the theme with which I began. We represent a large and important institution within a uniquely American industry. Unless the CFTC is mandated by Congress to adhere to the demands of the free market, its restrictive policies will stymie our competitive stance, materially affect our ability to grow, and ultimately force some of our hard-earned business to other market sectors or foreign competitors.

We seek your assistance. We need to remind our regulator that there is a limit to the costs that can be imposed without harm to the industry. There is a need to guage the benefits to be expected from that regulation and to weigh those benefits against the benefits of substitute solutions which may be less costly to the industry. We are close to the point where increased costs will drive our business overseas.

We always have had the protection of the public as our top priority. Our self interest in promoting our markets, demands no less than that to insure public confidence. In writing and promoting contracts useful to industry and agriculture, we know our self interest dictates that we do the best job possible. We are eager to keep pace with changing market demands and conditions. Again, our self interest demands no less.

The CME has an enviable record of protecting public customers from default and abuse. We pledge to continue. We cannot, however, maintain our markets at their current high level of efficiency and usefulness in the face of unnecessary and costly regulation. With the help of this reauthorization process, we hope that a successful and mutually acceptable accommodation can be reached with our regulators.

(Letter of April 21, 1986, follows:)



CHICAGO MERCANTILE EXCHANGE

John F. Sandner
Chairman of the Board

April 21, 1986

The Honorable Ed Jones, Chairman
Subcommitte on Conservation,
  Credit and Rural Development
1336 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

I would very much appreciate an opportunity to clarify and correct some of my recent testimony before the Subcommittee on Conservation, Credit, and Rural Development on March 18, 1986, respecting the reauthorzation of the CFTC.

In my written as well as oral statements relating to contract market designation, I criticized the CFTC's record stating that the agency was slow in approving new contracts, especially when compared to the record of the Securities and Exchange Commission. Unfortunately, my conclusion was based on analysis which, unbeknownst to me, was incomplete. This inadvertently resulted in an erroneous conclusion.

A complete analysis of facts actually supports an opposite conclusion. In the 19 futures market designations, since January 11, 1983, the average review period (not counting tolling time) was 7 months. In options, the record is even better, with an average of 6.4 months, exclusive of tolling time.

Accordingly, I take this opportunity to correct any erroneous impression created as a result of an incomplete analysis regarding the CFTC's record for contract market designation.

Very truly yours,

John F. Sandner

JFS:mls

cc: Susan Phillips, Chairman, CFTC
    Leo Melamed, Special Counsel, CME

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STATEMENT OF ALAN J. BRODY
PRESIDENT
COMMODITY EXCHANGE, INC.

REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

Before the Subcommittee on Conservation, Credit
and Rural Development, Committee On Agriculture,
United States House of Representatives

March 18, 1986

Mr. Chairman and Members of the Subcommittee:

I am President of Commmodity Exchange, Inc., popularly known as "COMEX," the world's largest futures and options market in precious metals. COMEX also makes substantial markets in major industrial metals. We accounted in 1985 for 98% of U.S. futures volume in Gold; 96% for Silver; and effectively 100% for Copper and Aluminum. Ranking third among the nation's futures markets, and first in New York City, COMEX has been serving the metals trade for 53 years.

It has now been four years since the activities and operations of the Commodity Futures Trading Commission (the "CFTC") were scrutinized on a comprehensive basis. In those years, there have been major changes in the leadership and staff of the CFTC. The agency's budget has felt the same pressures as other parts of the Federal Government. Meanwhile, futures volume has increased roughly 40%, not counting the commodity option programs that were inaugurated in 1982 and that now add another 20 million contracts per year to the industry total. These strong volume gains, however, mask what has been a deterioration in the profit margins in the futures business as well as a shake-out of many traditional commodity firms that could no longer compete effectively for that business. All in all, the last four years have been good ones for the markets but have not been problem free.

COMEX fully supports the concept of agency reauthorization. Accountability is critically important for a regulator like the CFTC that oversees the delicate machinery of the futures markets and, by dint of its performance, can either enhance or impede the delivery of risk-shifting services to American agriculture and industry. We are pleased to be afforded this opportunity to participate in that process.

The CFTC has recommended a number of changes in the Commodity Exchange Act. In this statement, I will review certain of those proposals and, in particular, the initiative to treat so-called "leverage contracts" like what they really are -- futures contracts. But first, allow me to discuss an event that occurred last year on COMEX that has caused all of us -- the CFTC, COMEX and the industry as a whole -- to raise our guard even higher against the risks of financial problems among commodity firms. I am speaking of the collapse in March 1985 of Volume Investors Corporation ("Volume").

A. Volume Investors Corporation

This development may be the most heavily publicized event to occur in the U.S. futures business for several years. Upon reflection, the level of publicity was not surprising. After all, Volume was the only futures firm to collapse in 1985. That was newsworthy, especially to a press that had grown weary of the litany of insolvencies in other financial sectors -- 120 banks and 57 thrift institutions failed in the same period (nearly 500 savings-and-loans, in fact, are now operating while technically insolvent); and 12 securities broker-dealers were also placed in liquidation. Nor need I mention to this Subcommittee the thousands of family farms and tens of thousands of small businesses that disappeared in 1985. Therefore, while the Volume matter deserves the serious attention that it has received, it remains a tribute to the futures community, including COMEX, that the attendant publicity is in part a response to the rarity of failures in this industry.

As you may know, the Gold futures market was not volatile during 1984 and early 1985. On two days in March 1985, however, dramatic price increases suddenly occurred. Indeed, the $44 (per ounce) jump in Gold futures prices was the greatest for any two-day period in the market's history. At the same time, the premiums paid for Gold options on COMEX increased as much as 700%.

One of the COMEX firms most heavily involved for customers in the Gold market was Volume. While Volume had more than twice the net capital required by the CFTC in the days immediately preceding the dramatic rise in Gold prices, the surge was so great that even Volume's cushion was to prove insufficient, especially when a second event occurred. Three customers of Volume, each a large trader in Gold options, refused to pay margins to Volume in the vicinity of $15 million. These defaults led to Volume's own failure to pay margins to Comex Clearing Association, Inc., a corporation that clears COMEX transactions.

After the default by Volume to the Clearing Association occurred, the firm was restricted by the Clearing Association to liquidating the open positions on its books. A suspension of the firm by COMEX also had the effect of closing Volume to new business after that date. The CFTC itself took action by seeking a court-appointed receiver for Volume and, one day after the default, a receiver was named and took control of Volume's affairs.

An examination of Volume's books disclosed that, as a result of the default, the company had roughly $3.5 million less than would be necessary to reimburse all customers with equity balances as well as most general creditors, despite the injection of $9 million by the Comex Clearing Association.

Immediately, COMEX began a search for sources of funds to satisfy the remaining shortfall. One plan was fashioned in the summer of 1985 between COMEX, the Clearing Association, the receiver, and the two owners of Volume, consisting of $4.1 million toward customer repayment. When a pre-condition to completion of the plan failed to occur on time, however, one owner of Volume withdrew from the program and the fund was reduced by roughly one-half. In a matter of days, the plan was revitalized among the remaining parties, including COMEX which agreed to advance up to $2,850,000 to the receiver to accelerate the pay-out. Court approval of this plan was received last month and a final distribution to eligible Volume customers has now been completed.

COMEX is not the first futures market to face the difficulties of a failed firm -- the Chicago Board of Trade, Chicago Mercantile Exchange and the Minneapolis Grain Exchange discovered a shortfall in customer funds at the insolvent "Q" Commodities firm some years ago and, because "Q" was a member firm, developed a rescue plan for customers just as COMEX has now done. Thus, while the risk of such an event is historically quite low, it is not a phenomenon limited to any particular exchange or any particular region of the country.

While the Volume situation has now concluded on a positive note, with customers better protected than in nearly any other industry, it has raised a number of broader policy questions about crisis control as well as preventive measures for the future. COMEX has devoted immense time to this subject, recognizing that it cannot be content to simply make customers whole but must also endeavor that customers will not face this problem again anytime soon.

The CFTC has also been assessing the implications of the Volume events, with a view toward regulatory fine-tuning. As you may know, the CFTC had personnel on the scene during the critical period and COMEX kept the CFTC's leadership apprised of what was happening on a continuing basis. Frankly, we are disappointed that the CFTC is now suing COMEX for decisions that it could have easily influenced at the time, but chose to remain passive about. However, that will be resolved in a different forum. Rather, I would like to address here just two of the CFTC's post-Volume regulatory initiatives.

B. Net Capital Requirements for FCMs

After the Volume event, the CFTC proposed to change the net capital requirements for futures commission merchants ("FCMs") so that their resources would have to increase substantially if open market positions at the firm became concentrated in a few hands. As you may know, and as the press has widely reported, the CFTC's first proposal in this regard would have had a crippling effect on FCMs, including some of the largest and most respected grain merchants and financial institutions in the United States. Moreover, the capital changes would not obviate the need for emergency action where positions become concentrated suddenly and unexpectedly. In any event, the CFTC has withdrawn that proposal for further study. We will endeavor to work with the other exchanges, the brokerage community and the CFTC toward a system of financial strength that is effective but not excessive.

C. Customer Account Insurance

A second significant initiative of the CFTC has been to examine a system of customer-account insurance. This is not a new idea. The securities industry has had such a program since the early 1970's under the aegis of the Securities Investor Protection Corp., or "SIPC." The CFTC, at Congress' direction, studied the efficacy of such a program in the mid-1970's and concluded that the loss experience for futures customers was too moderate to warrant the creation of an official insurance system. Even as recently as the CFTC's 1982 reauthorization, the agency reported annualized losses to futures customers of less than $200,000, as contrasted with SIPC's history of about $10 million per year.

Those statistics have not changed materially since 1982. The COMEX-led reimbursement program following the Volume collapse is expected to result in a zero (0%) loss of customer equities. And, even if COMEX and other volunteers had not stepped forward, the annualized customer losses in the futures industry would still have remained very low.

The reason for this low loss rate is the unique system of customer-funds segregation initiated by Congress in 1936. By setting customer deposits apart from the funds available to an FCM for its own use, the failure of a firm has normally left completely intact the money belonging to customers. COMEX supports this segregation program and, looking at the statistics, believes that more study is needed before deciding whether to create and perpetuate a SIPC-type scheme for the futures markets. Would the program's administrative costs alone exceed each year the amount of insurance paid out to customers? If we assume realistically that the program's costs will be ultimately borne by customers in the form of higher transaction expenses, could it become a net detriment to them?

Aside from these considerations, the National Futures Association ("NFA") has completed a preliminary review of the account insurance issue, including an effort to identify the many issues that would need to be answered before final conclusions are reached. COMEX believes, therefore, that it would be premature to express a firm opinion until the NFA report has been digested and its many questions have been studied.

D. The "Leverage Contract" Problem

Now that the Volume situation is behind us, it is appropriate to direct attention toward a more persistent problem for the futures industry, namely, the purveying of futures contracts under other names by firms that offer neither the self-regulation nor the competitive pricing available on the designated contract markets.

For over sixty years, federal law has required futures contracts to be traded on government-approved exchanges. In order to obtain approval, exchanges must demonstrate a vigorous self-regulatory capability and must trade contracts that will attract commercial hedgers to their marketplace. All futures contracts that are not traded on exchanges are banned under federal law.

Today two firms are retailing off-exchange futures contracts directly to the public. These aberrant contracts are called leverage contracts. Over the past decade, the firms selling these contracts to the public have waged a largely successful campaign to confuse the public, the CFTC and Congress as to the true nature of a leverage contract. That campaign is now about to end. In the past year, the CFTC and major futures exchanges have agreed that leverage contracts are indistinguishable from futures contracts, as a matter of both law and economics.

The logical legislative response to this conclusion is that since leverage contracts are futures contracts, both instruments should be regulated in the same manner. COMEX joins the CFTC in strongly supporting this legislative approach. COMEX believes, however, that Congress should affirmatively and explicitly mandate that leverage contracts are futures, subject to the same regulation as all other futures, including being traded on designated exchanges. While S. 2045, as proposed by the CFTC, would accompli[illegible]alutary result indirectly, COMEX would prefer to rely on legislation that directly prohibits the off-exchange trading of these contracts, as provided in H.R. 3434. In any event, COMEX and the CFTC fully agree on the end result -- leverage contracts must be treated like all other futures.

As you know, to date the public record on leverage contracts is far from complete. In part, the futures industry is responsible for the lack of public knowledge on this subject.

In past hearings, COMEX and others have not adequately highlighted the serious problems and implications involved in leverage trading. To the extent that our past silence on this issue has been interpreted to reflect indifference, we regret having not fully informed you of our views.

To amplify the record, COMEX, the Chicago Board of Trade and the Chicago Mercantile Exchange conducted a comprehensive study of leverage contracts, which was submitted in the official record of the hearing held by this subcommittee on March 20, 1985. This extensive legal and economic analysis demonstrates that leverage instruments are futures contracts and represent the most serious threat to the legitimate futures industry that we have seen in a long time.

For more than ten years, a handful of leverage firms have sold their contracts to the public through over-the-counter, off-exchange trading. The resulting toll on the public has become increasingly severe. Millions of dollars of customer funds have been lost through a combination of unscrupulous, abusive sales practices and the financial fragility of leverage firms.

These intolerable public losses could be avoided by recognizing leverage contracts to be futures. The two instruments are indistinguishable. Both are standardized contracts, calling for the future delivery of a commodity in a specified quantity and quality. The purchase or sale price is agreed upon at the outset. And, the contracts can be satisfied either by taking delivery or -- as is usually the case -- by offsetting a position. Both instruments provide an opportunity to speculate on the future price of a commodity, like silver bullion, with no expectation that delivery usually will occur under the contract. Thus, unmistakably leverage contracts are futures contracts.

The catch is that in leverage contracts the leverage firm both determines the price and then takes one side of every contract. This self-serving feature is in our view what keeps wise and institutional investors out of this market. Our study shows that the price of the commodity in a typical long leverage contract must rise at least 3 times more than in a comparable futures contract, for a leverage customer just to break even. Small wonder that leverage seems to have little interest for any trader but the most naive. As one former CFTC official has been quoted as saying, leverage is a "shell game, in which the company bets that you lose and then makes certain that you do."

Numerous reasons support regulating leverage like all other futures.

First, all off-exchange futures are otherwise prohibited. The sixty-year statutory requirement that futures be traded on an exchange is essential to the regulatory scheme for futures trading. Congress has wisely concluded that futures contracts will serve their important economic purposes -- hedging and price basing -- only when traded under vigorous exchange self-regulation, subject to federal government oversight. Leverage represents an unjustified exception to this longstanding principle.

Second, off-exchange instruments are prone to fraud. In the absence of exchange self-policing, Congress has correctly feared that the public would be subjected to commodity transactions offered by bucket shop operators and con artists. Every recent scandal involving commodity-type instruments and substantial customer fraud has occurred in connection with the offer and sale of instruments not traded on CFTC-designated exchanges (London options in the 1970's; precious metals frauds in the 1980's).

Third, leverage firms have a record of significant fraudulent and unlawful activity. Approximately 11%

of all customer reparation claims filed with the CFTC since 1980 have been directed at four leverage firms. CFTC reparation decisions also reflect a long list of adjudicated frauds by leverage firms. The CFTC's enforcement division has brought at least one proceeding against each leverage firm for unlawful misconduct. Thus, leverage represents yet another example of off-exchange commodity fraud that underscores the wisdom of Congress' requirement that futures contracts be traded on exchanges.

Fourth, leverage contracts are purely speculative instruments; no hedgers use leverage. Leverage firms readily admit that no commercial hedgers trade leverage contracts; leverage firms sell their contracts only to speculators. In futures, where hedging is prevalent, speculators assume the price risks hedgers seek to avoid. In leverage, where hedgers do not exist, leverage speculators do not assume price risks for anyone, but merely provide income to the leverage firms. Congress traditionally has expected futures contracts to serve a hedging or economic purpose. Leverage serves none and should not be tolerated.

Fifth, no CFTC rules prohibit leverage manipulation, although all leverage prices are inherently artificial. Leverage prices are fixed by the leverage firms to ensure their profits, not an accurate reflection of supply and demand factors. Exchange-traded futures prices are set by the market, based upon an open and competitive outcry auction. If a futures trader had dominant market power and intentionally used that power to create an artificial price, the CFTC would charge the trader with price manipulation. Under CFTC rules, however, a leverage merchant is free to do this very thing every day.

Sixth, leverage contracts are subject to fewer regulatory safeguards than futures. Before authorizing trading in a futures contract, the CFTC requires an applicant futures exchange to submit to an elaborate demonstration of its ability to regulate trading and the economic purpose of the contract. Leverage firms are not required to make a similar showing, nor could the leverage firms demonstrate any economic benefit to their contracts. Leverage contracts thus enjoy a competitive advantage over futures contracts.

Seventh, the CFTC has neither the resources nor the traditional expertise to regulate leverage. The CFTC's primary regulatory mission is to oversee the self-regulatory programs and operations of the exchanges.

Since leverage is traded off-exchange, no comparable self-regulation exists; instead, the CFTC must engage in responsive and burdensome direct regulation that saps the agency's resources. If the CFTC is directed to or decides to lift its moratoria, new firms may flock to the leverage business and further drain the CFTC's limited resources. Although the CFTC's existing leverage rules are well-meaning, the agency's ability to successfully administer and enforce these rules for an expanded leverage industry is, at best, doubtful.

Finally, reported leverage abuses undermine the CFTC's credibility and tarnish the reputation of the legitimate futures industry. Press reports and editorials have recently addressed the public protection problems of leverage. This media attention weakens the CFTC's reputation as an effective regulator and taints legitimate futures trading. Public, and even media, perceptions do not distinguish leverage from legitimate futures contracts.

History, law, economics and logic all point to one conclusion -- special and unequal leverage regulation is no longer acceptable. Congress has always directed futures speculators and hedgers to use exchange markets in order to channel and control their activities under the watchful self-regulatory eye of the exchanges. Consistent with this principle, Congress this year should enact H.R. 3434 to require leverage contracts to be traded under the same rules as all other futures.

In addition to the proposals that emerged after the Volume collapse, and the important leverage issue, a number of other developments and concerns have arisen that deserve mention.

E. Transaction "Audit Trail" Rules

Turning to another subject that has thus far been pursued through administrative regulations rather than congressional action, the CFTC has directed COMEX and the other contract markets to develop a method for recording the execution time of each transaction to the nearest minute. As originally proposed, the CFTC would have mandated a mechanized system of trade-time recordation.

In response, COMEX committed tens of thousands of dollars to a search for on-shelf devices capable of meeting that standard and, as of this date, has found none. Rather, it seems clear that new technology will be required. Accordingly, COMEX has faced two difficult and complex issues. First, could an effective device be designed? And, second, could the device (if even possible) be produced at less than prohibitive cost?

The first challenge -- creating a mechanical timing device -- includes an assessment of the ease of its use, the speed with which it can record the relevant time, and its reliability. A cumbersome, complicated device would invite massive errors. A device incapable of speedy recordation would slow down the rate of trade executions, causing waiting orders to suffer as market prices change in the interim. And an unreliable device would cause chaos when breakdowns occur.

The CFTC did not identify any existing commercial device that could meet those essential needs nor, based on COMEX's research, could it have done so. Similarly, the CFTC did not conduct an analysis of what such a device might cost on a per-unit basis. It remained wholly uncertain whether a manufacturer could or would make the investment necessary to produce such a device for the several thousand floor traders who populate the exchanges. Even if a producer could be found, it was not known whether those devices would cost $100 apiece, or $10,000 apiece.

COMEX, as well as the other contract markets, pointed out these infirmities to the CFTC while, at the same time, registering continued support for the concept of an effective "audit trail." In due course, the CFTC receded from its demand for a mechanical device and agreed to permit any form of time recordation, including the manual entry of execution times. Despite this concession, there continue to be grave doubts whether customers will gain from the final rule.

Specifically, the final rule will cause some new delay in the execution of waiting orders. The duration of each such delay might be debated, but the fact of delay cannot be. The question therefore persists whether the data gained from this additional step in the execution process is worth -- to the customer -- the inevitable and constant risk that trades will not be made at the best prices because of the attendant slow-down in filling their orders.

The CFTC has opined that the protections gained by customers from the new step outweigh the danger of poor executions, while the contract markets are highly dubious. We are not satisfied that the day-in, day-out accumulation of time records on millions of market transactions is really necessary for the CFTC's enforcement program, but may ultimately serve little purpose other than to create another tier of data for economists and academics to ponder.

The Commission's approach of setting a single standard that must be met by all exchanges also overlooks the critical fact that the contract markets often conduct trading under significantly different procedures. What is feasible for one exchange may be impossible for another. The Commission has erred by failing to recognize this fact, and should be more sensitive to the myriad trading styles used on the various exchanges. A case-by-case review of audit trail programs, therefore, is more appropriate.

In our view, the new time-recordation procedure, which is often characterized as a burden only on the exchanges, will need to be judged instead by its burden on customers. In this regard, it is regrettable that the CFTC has not committed itself to any study whatsoever of the possible adverse impact of time-recordation on the very group that is the supposed "beneficiary" of this new requirement. We would urge that such a study be conducted and that, if necessary, Congress so mandate.

F. Duplicative Enforcement Proceedings

The current system of dual regulation in the futures industry, consisting of the exchanges or the NFA in the private sector and the CFTC as the public agency, can give rise to wasteful and even unfair practices. No better example of this phenomenon exists than the duplicative disciplinary actions taken against the same person for the same misconduct by two or more of those prosecuting entities. With too great frequency, an exchange or the NFA charges a member with an offense that, upon conviction (or sometimes despite exoneration), leads to a copy-cat proceeding at the CFTC. Aside from the obvious inefficiency in this system, it impairs the dispensation of justice in a variety of ways.

Consider, for example, the strategy forced upon a potential accused who knows that multiple proceedings are likely to await him. At a minimum, he will have little incentive to settle either contest. He may refuse to give testimony in one setting on grounds that it could incriminate him in the other action (a genuine concern where the CFTC is involved, since the Act contains many criminal provisions). He may seek to delay one of the proceedings, citing the burden of defending himself simultaneously "on two fronts." Or he may fail to provide essential documents because they have already been seized by the other tribunal.

Consider, also, the dilemma presented to the judges in these situations. If found guilty, the offender should receive full and fair punishment. However, knowing that a second round of punishment will be meted out by another tribunal for the same misconduct, it would seem unfair for the judges to impose a full measure of discipline. Accordingly, justice is dispensed with one eye on the next proceeding that the accused must face. Conversely, the judges in the second proceeding may find it necessary or appropriate to re-shape their findings or penalties in light of what the first tribunal did. In short, the disciplinary process becomes confused if not confounding, for accused and accuser alike.

While it is true that, under futures regulation, the exchanges and the CFTC have somewhat different disciplinary powers available to them (for example, an exchange can expel an errant member from that market alone while the CFTC can bar him from all markets either temporarily or forever), there are common forms of discipline such as fines or, under CFTC rules, "civil penalties" where some rationalization of the process is possible. Another example might be the action taken by an exchange against a floor broker in which he is suspended from floor privileges, while the CFTC imposes the same restriction by suspending his floor broker registration. Coordination of penalties is possible and proper in these circumstances, and yet the CFTC seems little interested in doing so.

COMEX supports a system of cooperation between the self-regulatory bodies and the CFTC to avert the manifest injustice and profligate inefficiency of the present duplicative enforcement programs. In 1982, Congress admonished the CFTC to better coordinate its enforcement efforts with the disciplinary programs of the self-regulatory bodies, but little progress has occurred. We urge Congress to direct the CFTC once again to rectify this problem, either by unequivocal expression in the Act or clear mandate in the legislative history of this reauthorization.

G. Cost-Benefit Analyses

It is a principal failing of federal regulation generally, and of CFTC rulemaking in particular, that no burden or obligation is formally placed on the agency to demonstrate that the cost to the public of new regulatory programs is more than offset by the benefits that will inure from those initiatives. A case in point was the CFTC's audit trail proposal that would have mandated a mechanical time-stamping system without regard to what its current costs might be or whether its development as new technology would be prohibitively expensive.

COMEX believes that the CFTC should be required to conduct a cost-benefit analysis before adopting significant regulatory programs. In addition, good management dictates that on-going programs should be reassessed from time to time on a cost-benefit basis to determine whether they are (or ever were) worth the expense. Returning to the audit trail example, the CFTC should be put to the duty of studying whether the costs that customers will surely incur through delayed order executions under the CFTC one-minute recordation program exceed the quantifiable benefits of this new system. Not only has the CFTC failed to include that important analysis in its final rule, but appears to have been oblivious to its value.

H. The Options "Pilot" Program

Beginning in August of 1982, the CFTC reintroduced commodity options trading on the nation's contract markets. While embellishments have been made since then, the "pilot" status of the program has remained unchanged since that date. This, even though the CFTC had announced that the pilot phase would end in October of 1985. And this, despite a nearly spotless record for the options program since its initial introduction.

The CFTC's reluctance to adhere to its own cautious deadline for the pilot stage of the options program is mystifying to us. The collapse of Volume in March 1985 -- discussed earlier -- did not give cause to question the integrity or soundness of the revived options markets. On the contrary, approximately 20 million options per year are traded on the contract markets -- the equivalent of all futures trading in 1972 -- without fraud or scandal.

COMEX has urged the CFTC to proceed with the options program free from the onerous "pilot" restrictions, but our efforts have been unavailing. Congress should not permit the CFTC to be dilatory in its handling of the options program. It can be operated at this time under normal regulatory conditions without public peril, and it should be.

I. CFTC Re-Write of NFA Rules

COMEX cannot agree with the Commission's desire for power to change NFA rules unilaterally if it deems that revisions, additions or deletions are needed. While it is correct that the CFTC has authority in the case of contract markets to alter or supplement their rules under certain limited circumstances, it does not follow that such should be the case for the NFA. The NFA does not deal, for example, with market-wide emergencies where inadequate rules could exacerbate a market crisis and where, to avert that consequence, the Commission can take steps in advance to compel that relevant contract market rules be revised.

Moreover, the NFA has proven itself to be a responsible and responsive self-regulatory body, as the CFTC itself has found. Until such time as the CFTC can demonstrate an uncooperative attitude at the NFA toward considering rule changes suggested by the CFTC, there will be no need for the CFTC to assert absolute power over the contents of those rules.

J. Period of CFTC Reauthorization

As stated earlier, COMEX favors the reauthorization process as an effective way to assure accountability of federal agencies like the CFTC. Otherwise, they might labor in relative obscurity for many years, going about their highly technical work with little or no public review.

Since the creation of the CFTC, the reauthorization cycle has been four years: 1974 (creation), 1978 (review) and 1982 (review). This interval seems well suited to the meaningful evaluation of the CFTC's performance. Old programs are given a 4-year "check-up" while newer programs are reviewed after an appropriate testing period. A longer hiatus -- such as the 6-year cycle proposed by the CFTC -- would leave poor policies in place too long. Accordingly, COMEX urges that the existing 4-year reauthorization cycle be preserved for the CFTC.

Conclusion

Mr. Chairman and members of the Subcommittee, COMEX commends you for the diligent oversight that the CFTC has received in the past, and for the continuation of that tradition in these hearings. The problem of Volume Investors Corporation is behind us, with no customer losses. The important question of whether futures trading -- even if called "leverage" -- should remain on the self-regulating, competitive exchanges has properly been raised and should be answered in the affirmative. As for other issues, our positions have been stated above. With your help, the CFTC will become an improved agency sensitive to the costs of its initiatives, the human hardships that duplicative discipline inflicts, the need to act in a decisive way on such matters as the options program, and the importance of tailoring its demands -- whether capital requirements, audit trail or other proposals -- to what can realistically be done.

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Statement of
John M. Damgard, President
Futures Industry Association
before the Committee on Agriculture
United States House of Representatives

Mr. Chairman and members of the Committee, I am John Damgard, President of the Futures Industry Association accompanying me today is Jack Lehman, Chairman of the FIA and Senior Executive Vice President of Shearson Lehman Brothers Inc. The FIA is the national trade association for the commodity futures and options industry. Our regular membership is composed of over 100 brokerage houses, called "futures commission merchants" or "FCMs". FIA - member FCMs are estimated to transact over 80% of the public customer trade on US commodity exchanges. Our association also counts among its membership, all US exchanges and many law and accounting firms, foreign exchanges and foreign brokerage houses and banks. While we value all of our members and strive to represent the "industry" as a whole, our roots are in the brokerage community and we remain, primarily an FCM association.

FCMs are the industry's link to the trading public. Our members serve public customers, be they farmers, mutual funds, pension plans, savings and loans or local or foreign governments. FCMs must assure the public that these markets are fair and answer to the public on those occasions when the perception is to contrary. Thus, we have a vital interest in thoughtful regulation of the market place and increased efficiency in the transaction of business. Our public demands this and we can accept nothing less.

The FIA recommends reauthorization of the Commodity Futures Trading Commission for a six year period. As I have observed the growth of the Commission over the past eleven years, I believe it has done a credible job in regulating -without hindering a marketplace that has grown 5 fold since 1974 and introduced 169 new futures and options contracts. The existence of a credible federal regulator has allowed these markets to grow and prosper and enjoy the participation of large institutional users and the public in general.

While the FIA is generally pleased with the evolution of regulation under the CFTC, there are a number of programs and issues, some of which are regulatory and not legislative in nature, about which I would like briefly to comment:

Options: A great deal of attention has been focused in the past year on the default of Volume Investors Corporation and its impact on the Commission's option program. As a result of the Volume default, the Commission identified what they believe to be various weaknesses in the current regulatory framework. Those perceived weaknesses and potential remedies are the subject of ongoing debate within the industry and between regulator and regulated. It is our hope that the end result will be a rational regulatory framework that does not drive the industry to its knees. Nevertheless, the options program should not suffer from a single controversial incident, nor should the current restrictions on expansion of the program be maintained. Presently, the exchanges are limited to a maximum of eight (8) non-agricultural options and two (2) agricultural. Particularly in the agricultural context, where there have been no problems whatsoever, the restrictions should be eliminated.

Insurance: The controversial Volume Investors problem gave rise to renewed cries by some that the commodity futures and options industry should provide insurance or customer account protection in some form.

The importance of customer confidence in the financial integrity of the futures markets is tremendous, and I would add, well-deserved. Between 1971 and 1984 customer losses amounted to $9.7 million in the commodities industry. During the same 13 year period, total securities customers claims amounted to about $690 million, for which SIPC paid out $153 million. Ten million dollars in securities customer losses were not covered by SIPC. Thus even with the SIPC program, customer losses in the securities area exceeded those in commodities. Insurance, in the securities industry and other segments of the financial marketplace, including banking, has presumably played a significant role in the protection of customer funds, but at what cost? Do market users exercise less than sound business judgement in selecting a firm when there is an insurance program in place? Are the firms themselves less cautious in their hiring of employees, screening of customers or handling of accounts and cash? Do the self-regulatory organizations enact fewer, or less stringent rules designed as preventive measures? If the answer to any of these questions is "yes", then the trade-off for having insurance cannot be taken lightly. While the present system is certainly not perfect, it has worked remarkably well for many years. The best "insurance" is a strong clearing organization, properly capitalized firms and a sound self-regulatory framework with competent CFTC oversight that is effectively and consistently enforced.

Hedging: The CFTC's hedging definition, promulgated prior to the development of the financial futures markets is not appropriate for today's financial futures markets. Rule 1.3(z), which defines hedging, was promulgated in 1977 for the agricultural markets; it is not adaptable to the financial futures and options markets, or their institutional participants. As a result, the activities of commercial and institutional users of financial futures have been unduly restricted. The situation is long overdue for reexamination and promulgation of a more realistic hedge definition for financial futures.

Position Limits and Aggregation: Related to the issue of the dated hedging definition are speculative position limits, which limit the number of non-hedging positions that may be held in any futures or option contract, and the CFTC's current aggregation policy, which requires a trader to combine the positions in all accounts owned or controlled by the trader for purposes of applying speculative position limits. FIA believes that the existing levels of speculative position limits and the CFTC's aggregation policy are hampering legitimate uses of some of the commodities markets, without any countervailing regulatory benefits. Thus, existing CFTC limits on agricultural futures and exchange-set limits on other contracts adopted at the CFTC's insistence are frequently unrealistic in view of the substantial growth in the supply of the underlying commodities and the expansion and growing internationalization of the agricultural and other commodity markets over the years. The futures and option markets cannot serve the needs of hedgers seeking to lay off their risks without the active participation of traders who provide the necessary depth and liquidity in the markets. Also, FIA believes that traders, including commodity pools and other institutional participants, should not be required to aggregate positions in all accounts owned by them if those separate accounts are being traded independently of one another. This is another unnecessary restriction on the liquidity of the markets. The potential for disruption or manipulation of commodities market prices, which is the rationale for speculative position limits and aggregation, is not present where a trader merely owns a position in an account, but does not control trading in that account. The CFTC needs to rethink its policies on speculative position limits and aggregation in light of the changing conditions of the commodities markets and the growing needs served by commodity futures and options.

Off-exchange transactions: The FIA urges the Congress and the Commission to be extremely cautious in considering any legislation or regulation in the very broad area of "off-exchange" transactions. There is clearly a legitimate role for the CFTC in enforcement of Section 4 of the Act which requires that all futures contracts be traded on a designated exchange. It does not follow however, that all off-exchange transactions violate Section 4. There are a myriad of vitally important non-exchange financial transactions that cannot legitimately be characterized as off-exchange futures, and should not be. We fear that "the easy way out" for regulators would be to characterize these transactions in such a way -- as off-exchange futures -- to destroy these markets, which legitimately provide hedging and investment opportunities for large and knowledgeable participants. The interbank currency market, interest rate swaps, forward rate loans/deposits, cross-currency rate swaps, Eurocurrency loans with marketable caps and many more financial transactions and arrangements provide corporate treasurers and financial officers with the flexibility to operate in their economically most efficient manner.

In some instances, these varied financing arrangements, and perhaps some not as yet even developed, will best serve commerce. It would be a tragic mistake to interfere in such sophisticated markets, without first fully exploring the ramifications of such intervention.

Enforcement: The FIA continues to be concerned about what has become known in the enforcement context as "double jeopardy". The exchanges have the authority, pursuant to Section 8c of the Act, to bring disciplinary proceedings in accordance with their own rules, against their members, for a wide variety of offenses. The Commission has in the past, often filed complaints against those same exchange members for the same violations for which they have already been prosecuted and sanctioned by the exchange. Rather than reprosecute, the CFTC should be utilizing its authority to review exchange actions. The CFTC's practice of reprosecuting can stifle the exchanges' own disciplinary proceedings and discourages offending parties from cooperating with the exchange disciplinary body.

Audit Trail: The CFTC published a final rule on January 14 requiring that each side of all trades have, on the trade register, an execution time identified to the nearest minute. The Chicago Mercantile Exchange and Chicago Board of Trade have presented the Commission with a proposal for compliance with the Commission rule. We are very pleased with the efforts being made by the CFTC staff and Commissioners and representatives of the exchanges to develop this proposed system for the enhancement of the audit trail. We believe that this serious undertaking is a very positive step in what should be a continuing process of improving the systems by which a day's trading can be reconstructed. As technology advances and markets expand, the industry must strive to keep pace in all areas, including audit trail. The audit trail issue presents highly technical problems whose resolution lie properly in the regulatory arena. We applaud the motives of the CFTC and look forward to continuing progress, where the CFTC, FCMs and exchanges work together to foster greater public confidence in the markets.

NFA: The FIA applauds the progress of the NFA over the past three years. It has proven itself to be a self-regulator responsive to its oversight authority. We join with the NFA and the exchanges in opposing the CFTC's request for additional rulemaking authority over the NFA.

Mr. Chairman, the FIA appreciates this opportunity to present its views to the Committee. The FIA offers the Committee the assistance of its staff and membership in this most important undertaking.

STATEMENT OF
GARY L. SEEVERS
GOLDMAN, SACHS & CO.

BEFORE THE
SUBCOMMITTEE ON CONSERVATION,
CREDIT AND RURAL DEVELOPMENT
OF THE
COMMITTEE ON AGRICULTURE
U.S. HOUSE OF REPRESENTATIVES

March 18, 1986

Mr. Chairman and Members of the Committee, it is a pleasure for me to testify on two regulatory issues that limit the use of the new financial futures and options markets by financial institutions.

My name is Gary Seevers and I am employed by Goldman, Sachs & Co., an investment bank and a registered FCM. Prior to joining Goldman Sachs, I was a Commissioner of the Commodity Futures Trading Commission and prior to that a member of the President's Council of Economic Advisers. I am an industry member of the Board of Governors of the Chicago Mercantile Exchange and on several boards and committees of New York exchanges.

At Goldman Sachs I am responsible for our overall work with clients who use futures and options markets for hedging and trading.

The primary purpose of my statement is to emphasize to the Committee that the Commission's definition of hedging needs to be revised and updated. This revision should be done by the Commission and should focus on the new financial futures and options markets. A revised definition is needed, among other reasons, to reflect certain important and legitimate ways that financial institutions already are using these new markets. In addition, I want to highlight the need to exempt certain institutions from unnecessary registration as commodity trading advisers.

The hedging definition is important from a regulatory standpoint because it is the basis for making exemptions from speculation position limits and because it is a requirement for institutional investors to obtain exemptions from registration as commodity pool operators.*/

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*/ A comprehensive summary is given in "The CFTC's Hedging Definition--Development and Contemporary Issues" by Blake Imel, Ronald Hobson and Paula Tosini, October, 1985.

Prior to the creation of the Commission, Congress had defined hedging in the Act. However, this responsibility was transferred to the new Commission in 1974. In the words of the House Committee Report, which the Conference adopted:

> "The goal of the Committee in replacing the so-called 'mechanical test of hedging' in Section 4a(3) of the present Act was to free the Commission to define hedging in a manner more consistent with the times and practices of the industry. It is not the intent of the Committee that it be used to overly restrict industry use of the futures market for hedging."

The Commission carried out its responsibility by adopting a revised definition in 1977. An important feature was an entirely new general, or conceptual, definition of hedging intended to complement the specific, itemized regulatory definition. Although the 1977 definition took some account of the new financial futures which were still in their infancy, it was oriented primarily toward agricultural and other physical commodity futures. Moreover, the definition did not even consider options which are such an important part of the markets today.

The 1977 definition is still sound and adequate for commodity futures and also for many users of financial futures including, for example, government securities dealers. But the definition is not adequate for all users and does not cover all valid uses. In particular, depending on how the definition is interpreted, it may not recognize certain uses by institutional investors such as pension funds and mutual funds or the investment advisers, bank trust departments and insurance companies that manage such funds.

For these institutional investors, the advent of financial futures and options created a low-cost, efficient vehicle for managing existing portfolio risks and for adjusting a portfolio's risk parameters. Futures and options have also been instrumental in creating entirely new investment products and strategies. Although some of these uses would clearly qualify as hedges under the 1977 definition, other uses would not, given the Commission's present interpretation of the 1977 definition.

In particular, the 1977 definition refers to futures "transactions or positions [which] normally represent a substitute for transactions ... in a physical marketing channel, and where they are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise ... ."

The words physical, reduction of risks and commercial enterprise are simply not suitable for institutional investors in financial assets who have the responsibility to make and implement investment decisions that often require choices between various levels of risks undertaken and expected yields.

As an immediate remedy, I believe the Commission should make four specific changes in the 1977 definition. First, it should recognize the concept of "prudent risk management" by institutional investors in the general definition. Second, under the enumerated definition, the Commission should recognize, as a hedge, long futures positions against holdings of cash or cash-like positions. Such long positions should qualify on the same basis as short futures positions against holdings of assets. Third, the Commission should be prepared to consider under the non-enumerated portion of the definition so-called synthetic securities that are heavily or totally dependent on futures or options positions. Fourth, the Commission should complete its ongoing effort to incorporate options in the definition.

These modifications, at a minimum, are necessary if the full economic benefits of futures and options markets are to be realized. Otherwise, regulation will limit legitimate and valuable uses by institutional investors. The hedging definition, as already indicated, is important because it is the basis on which institutions seek exemptions from speculative position limits and exchanges grant exemptions.

A closely related rule is aggregation, which requires the combination of positions that are either owned or controlled by the same entity. Aggregation should also be examined to determine how the rule needs to be changed in order to avoid unwarranted constraints on the use of futures and options by institutional investors. For example, a pension fund's assets which are managed by third parties should not be aggregated with assets managed by the fund itself.

Beyond the specific issues of exemptions from speculative limits and aggregation, I believe the Commission should be in the forefront of articulating the essential economic functions of these new markets.

The Commission, which has a good overall record in this score, should not forget that many parties--market users and potential users, other regulatory agencies, the Congress and the general public--look to the Commission for guidance. The concept of hedging has become synonymous with legitimacy. A narrow definition of hedging--framed for the age of physical commodities--will have the effect of foreclosing many market users from legitimate uses of financial futures and options markets.

Unfortunately, the definition of hedging has not been updated in nearly a decade--a decade in which there have been extraordinary developments in the marketplace. It is time the Commission devotes its highly capable resources to this important task.

Let me turn briefly to the problem of institutional investment managers registering as commodity trading advisors or CTAs. Many of the clients we work with have found the requirement that they register as a CTA not only burdensome but also inappropriate to the way they use futures and options. The basic problem is that the CTA requirements are designed for entities that provide advice and manage money in the speculative use of futures and options. I recognize that these entities are often not otherwise regulated and should be registered and regulated by the Commission. However, the same requirements are not suitable for institutional investment managers of securities portfolios that use futures and options as an adjunct to their portfolio management strategies. Equally important, these institutional investment managers are regulated by other regulatory agencies and must generally comply with stated investment policies or prudent investment rules.

It is clear, based on my experience, that some form of statutory or regulatory relief should be provided for insurance companies and others who are registered with the Securities and Exchange Commission as investment advisers and who use futures and options in connection with management of a securities portfolio. Tomorrow, John D. Brookmeyer, Jr. of The Prudential Company of America will testify on behalf of several insurance companies about what form this relief should take.

Action in this area will remove obstacles to expanded use of financial futures and options, and will release Commission resources to focus on other areas without creating any regulatory gaps.

Thank you!

TESTIMONY OF
THEODORE THOMTE, PRESIDENT
NATIONAL ASSOCIATION OF FUTURES TRADING ADVISORS

Good morning. My name is Theodore Thomte. I am President of the National Association of Futures Trading Advisors (NAFTA). NAFTA is a national trade association of approximately 175 commodity money management professionals, who manage approximately $800,000,000 in commodity investments for over 5,000 clients. Our members are active as commodity trading advisors and commodity pool operators; they operate or advise a substantial number of the pools and managed accounts currently in existence. Our segment of the futures industry is relatively new and has grown rapidly.

We welcome this opportunity to report to the Committee on our experience in operating under the current regulatory structure governing the futures industry. We wish to commend the efforts of the CFTC and the NFA in regulating the industry, including our own highly specialized segment of the industry. In our opinion these agencies have demonstrated competence and professionalism in coordinating their regulatory programs, to the benefit of both the public and the industry.

We are especially appreciative of the CFTC's action in designating a special counsel for regulatory matters affecting pool operators and trading advisors - an action which we believe is generally symbolic of the CFTC's recognition of the highly specialized nature of our field.

We are also pleased to report that the National Futures Association (NFA) has met the expectations of our membership regarding self-regulation. The development of NFA and its assumption of growing responsibilities have to a great extent made regulation more efficient and more protective of the public interest.

We would like to focus on four areas of NFA accomplishment which we believe are particularly noteworthy: (1) registration, (2) arbitration, (3) audits and education, and (4) establishment of professional standards.

Registration

It has been our experience that NFA registration staff are accessible and knowledgeable. NFA has developed streamlined procedures which have made the registration process more efficient and less expensive for the industry. For instance, the NFA has devised a single application form where previously an applicant for multiple registrations would complete a number of duplicative forms. In addition, NFA has usefully informed registrants of registration renewal dates during the year.

As NFA has expanded its registration duties, testing requirements have also been established. NAFTA welcomes this development as a means of enhancing professionalism within our industry. Applicants are now required to demonstrate a working knowledge of the legal and compliance requirements pertaining to their activities.

Arbitration

The development of the NFA arbitration program is another promising aspect of NFA's growth. The NFA arbitration system has been in operation for almost three years and we believe that this forum for dispute resolution now provides a popular alternative to litigation and arbitration in other forums. The average time for resolution of a dispute through NFA arbitration is significantly shorter than that for litigation, and the costs of NFA arbitration are generally far less than those entailed in litigation. It has been our experience that the NFA has generally succeeded in holding arbitration hearings within six or seven months of filing - a commendable record.

Audits and Education

A third area of NFA accomplishment involves its comprehensive audit program. NAFTA is particularly interested in the NFA audit program because it constitutes the primary mechanism for overseeing compliance of pool operators and trading advisors with CFTC and NFA rules. Although this audit function could be performed with only a narrow focus on enforcement, NFA audits have concentrated on member education as well.

Many NAFTA members are relatively small pool operators or trading advisors. These members have been assisted by NFA staff in implementing changes in record keeping and reporting procedures, and in modifying their disclosure documents to conform to applicable CFTC and NFA requirements. NAFTA believes that an essential element of industry self-regulation is education of members as to their regulatory and compliance responsibilities because a large percentage of technical violations arise from incomplete understanding of applicable rules. As a membership organization, NFA serves its members and the public well by counselling its members on matters related to regulation and compliance. We believe the good start that has been made in that area should be built upon and expanded.

NAFTA specifically wishes to acknowledge the assistance received by NAFTA members from NFA staff in developing and improving their compliance procedures. The NFA staff deserves praise for its recent completion of a special compliance guide for trading advisors and pool operators. This guide is written in plain language and at the same time gives detailed and helpful compliance guidance.

Development of Professional Standards

A fourth area of NFA accomplishment concerns the development of high professional and ethical standards for our segment of the futures industry. The NFA's efforts in this area have been impressive and they include:

(1) an effective industry-wide rule for discretionary accounts,

(2) an advertising rule which governs both the form and content of promotional material in order to encourage communications with the public which are fair and meaningful, and

(3) the development of a "know your customer" rule that focuses on the customer's understanding of the relationship of his trading objectives and the risks of trading in commodity interests.

These examples of NFA performance underscore a development viewed by NAFTA as having even more important long-run consequences: the development of an effective working relationship between NFA and the industry, characterized by a high degree of mutual respect, a willingness to understand conflicting viewpoints, and a desire to accommodate them where possible. NFA accomplishments since its inception have been made possible by a working environment conducive to effective self-regulation.

Finally, we wish to comment on several specific issues that have been raised in the course of these hearings. We support the CFTC's proposal to extend the period between Congressional reauthorizations of the agency to six years from four years. We believe a six-year reauthorization period would contribute to regulatory efficiency by conserving the resources of the CFTC, the industry, and the Congress.

Other commentators have recommended that the CFTC's definition of "bona fide hedging transactions" be modernized to bring it in line with prudent trading strategies now employed by many investment managers in connection with financial futures transactions. We fully support this recommendation, and we are hopeful that commodity money managers will be accorded the same regulatory treatment that investment advisors who hedge client portfolios are accorded.

We also support several measures designed to strengthen the enforcement efforts of the CFTC and the NFA. Specifically, we support the CFTC's proposal to eliminate the automatic stay provision currently applicable to NFA disciplinary actions. One of the most effective disciplinary tools employed by the NFA has been the "MRA" or member responsibility action. The MRA is a summary procedure which, in our experience, has been effective in obtaining prompt compliance with NFA rules and providing protection to customers. However, section 17(h) of the Commodity Exchange Act currently permits the respondent in an MRA action to secure an automatic stay of the action merely by filing an application for review with the CFTC. We support the CFTC's proposal to place appeals of NFA disciplinary proceedings on equal footing with appeals of exchange-imposed sanctions (where a stay can be granted by the CFTC but is not a matter of statutory entitlement).

In addition, we support the CFTC's proposal to make explicit that the proscriptions against fraud and other abusive practices in Section 4b of the Commodity Exchange Act apply to the marketing of illegal, off-exchange futures contracts. We agree that the purveyors of off-exchange futures contracts should not be able to defend fraudulent conduct on the basis of a narrow reading of Section 4b.

Thank you for your attention and we would be happy to elaborate our views to members of the Committee or its staff.

STATEMENT OF
THOMAS A. RUSSO
CADWALADER, WICKERSHAM & TAFT

BEFORE THE
COMMITTEE ON AGRICULTURE

March 18, 1986

Mr. Chairman and Members of the Committee, I appreciate this opportunity to testify before you, on behalf of a number of my commodity clients, regarding several issues that may have a significant impact on the long-term growth and utility of the futures markets.

I am currently a partner in the law firm of Cadwalader, Wickersham & Taft, but formerly served as the first Director of the Division of Trading and Markets of the Commodity Futures Trading Commission (the "CFTC") and as a Deputy General Counsel of that agency. I have also served on the staff of the Securities and Exchange Commission ("SEC") and have written extensively on both securities law and commodities law matters. Those writings include co-authorship of a text on the regulation of securities broker-dealers and authorship of a two-volume treatise on the regulation of the commodity futures and options markets.

Introduction

The issues I wish to discuss today relate primarily to the CFTC's speculative position limit rules and are significant because position limits, in effect, serve as "gatekeepers" for the commodity futures and options markets, determining, in a relatively rigid and mechanical manner, who may participate freely in those markets and who may not. Position limits can force traders to employ other markets or instruments to satisfy their investment and portfolio management needs and thus play a critical role in shaping the long-term fate of the commodities markets.

Because of the far-reaching ramifications of limits, it is essential that the CFTC's position limit rules and policies keep pace with the evolution of the futures markets and allow legitimate market activities to go forward in an unimpeded fashion. I fear, however, that this has not happened. In particular, I believe that: (i) unduly low and restrictive limits currently apply to many futures and option contracts; (ii) the CFTC's definition of "bona fide hedge" positions is badly in need of updating; and (iii) the manner in which positions are aggregated for purposes of determining compliance with limits unnecessarily impairs the efficient operation of the commodities markets. On a related topic, I believe that the CFTC's commodity trading advisor ("CTA") regulations also stand as an unnecessary barrier to the efficient use of the markets by certain regulated entities.

This statement addresses each of these concerns individually, after laying a bit of position limit "groundwork."

Background

The futures markets were traditionally thought to consist of two different types of participants: hedgers and speculators. Hedgers, in essence, enter the markets to offset the price risks to which their business activities expose them, while speculators enter the markets to assume, and potentially benefit from, price risks they would not otherwise face. Both types of traders are essential to the markets -- hedgers because their participation provides the raison d'etre for those markets and speculators because their participation provides the liquidity necessary to allow those markets to achieve their principal economic purpose. However, those two types of traders have been welcomed with markedly different degrees of enthusiasm.

Most notably, speculative participation in the commodities markets has been artificially restricted by rules limiting the number of "speculative" contracts a trader may hold or control in a particular future or option. A trader's ability to amass "bona fide hedge" positions is, on the other hand, essentially unfettered. Currently, the position limits for sixteen actively-traded agricultural futures contracts -- including contracts on wheat, corn, soybeans and cotton -- are found in the CFTC's regulations, while the position limits for all other futures contracts are found in the rules of the various commodity exchanges. However, most of the latter limits were imposed only after the CFTC adopted Rule 1.61 in October of 1981, which directed the exchanges to establish limits for all futures and option contracts on which no CFTC limits were then in effect.[1] See 46 Fed. Reg. 50938 (Oct. 16, 1981), codified at 17 C.F.R. § 1.61. Statutory authority to impose position limits was granted to the CFTC's predecessor agency in 1936, when the Commodity Exchange Act ("CEA") was enacted, and appeared to stem, at least in part, from a post-1929 bias against "speculation."[2]

Position limits are theoretically designed to: (1) prevent the manipulation of market prices; (ii) guard against "unreasonable or unwarranted" price movements thought to flow from extraordinarily large speculative positions; and (iii) minimize the price impact of the liquidation of sizable positions. Id. However, the utility of limits has long been the subject of debate -- particularly for contracts that are cash-settled, that involve commodities that have very broad cash markets or that may be arbitraged with liquid markets in other countries.

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[1] Prior to the enactment of that rule, only 17 actively traded futures contracts were subject to exchange limits; 51 contracts, including contracts on foreign currencies and Treasury securities, were traded free of limits.

[2] See, e.g., T. Russo & M. Bartlett, "Speculative Position Limits: Act II," The Commodities Law Letter (November 1981) [hereinafter "Russo & Bartlett"].

The Need to Increase Limits

CFTC Limits: The need to increase the levels at which position limits have been set is particularly apparent in the case of the futures contracts that are subject to CFTC limits. The current limit on cotton futures, for example, is only 30,000 bales and has remained unchanged since 1940. Similarly, limits on wheat and corn were set at two million bushels in 1938 and have been increased by only one million bushels since that time.

In this regard, a 1976 Report by a CFTC Advisory Committee urged that existing limits be "substantially increased," because those limits have been frozen at roughly the same levels for many years, while the size, liquidity and hedging use of the markets has increased.[3] Moreover, when the CFTC adopted Rule 1.61, each member of the Commission expressed concern about the appropriateness of the position limits contained in the CFTC's regulations. One Commissioner noted, for example, that the CFTC hasn't been "doing the job it should be doing in changing with the times;" and, the Commission's Chairman expressed the view that the CFTC should scrutinize its existing limits "at the earliest possible time." See Russo & Bartlett, supra at 7.[4]

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[3] See Report of the CFTC Advisory Committee on the Economic Role of the Contract Markets at p. 28 (July 17, 1976) [hereinafter "Advisory Committee Report"].

Indeed, members of the CFTC staff have themselves conceded that the quantitative techniques used to arrive at the particular levels established "may no longer stand up to criticism" and "did not . . . support any specific level for speculative limits." See CFTC Office of Economics & Education, "Speculative Limits: An Overview" at 5 (1975). And, the CFTC staff also has concluded that "the exact level at which limits were set appears to have been determined more by subjective than by empirical criteria . . . ." Id. at note 40.

Despite all this criticism and concern, however, no steps have been taken to review existing limit levels. Congressional "encouragement" to move in this direction would thus appear to be in order. The lack of empirical support for existing limit levels, the explosion in futures market activity during recent years and the dearth of limit level changes all suggest that a thorough overhaul of the CFTC's limits is long overdue. In particular, the limits imposed on a number of futures contracts could arguably be expanded significantly in the more distant months of those contracts, because manipulation and congestion are unlikely to pose problems until the delivery month.

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[4] Various futures market economists also have suggested that CFTC position limits are too low for modern market conditions. See, e.g., A. Peck, "Increase Speculative Limits?," Commodities Magazine at 20, 28 (Feb. 1980); T. Hieronymous, Economics of Futures Trading 337 (2d ed. 1977).

Rule 1.61 Exchange Limits: The position limits established pursuant to Rule 1.61 -- although of more recent vintage than the CFTC's limits -- would also benefit from careful review. On the most basic level, the promulgation of that rule has frequently been characterized as an overreaction to the March 1980 silver market crash. In light of the increasingly eclectic nature of the instruments on which futures contracts are traded, the notion that events in one futures market have automatic relevance for other types of futures is not only dubious, but dangerous.

In this regard, a CFTC Advisory Committee observed in 1976 that:

> Speculative position limits would have almost no utility at all for many of the newly-regulated commodities. Those with a dependably broad supply (no seasonal factors, no storage problems, easy transportability), and those which may be arbitraged from highly liquid markets in other countries, would derive even less benefit than speculative position limits usually provide. In those commodities which are also traded on liquid futures markets overseas, such limits would be ineffective at best and at worst could drive trading away from the U.S. exchanges.

See Advisory Committee Report, supra at 28.

Similarly, a 1977 study by the Office of the Chief Economist of the CFTC was equally adamant in its conclusion that limits play no useful role in some futures markets. This study observed that the price impact of large speculative positions is qualified by a number of individual market characteristics, including: (i) a commodity's breadth of supply; (ii) its storeability; (iii) its fungibility; (iv) the cost of transporting it; (v) the ease of delivery on its futures contract; (vi) the degree of arbitrage between its cash and futures markets and between geographically dispersed cash markets; (vii) the liquidity of its cash and futures markets; and (viii) the existence of other futures markets. See Memorandum to the Commission from the Chief Economist at 2, 19 (June 24, 1977). This study stressed that these characteristics must be considered to determine whether limits would be of any value for a commodity and recommended that speculative limits be adopted "only for those commodities where they may have some possible benefit." Id. at 33, 35 (emphasis added). In addition, this study noted that, if the cash and futures markets are highly interrelated and the cash market is broad -- characteristics that are typical of most of the financial instruments on which futures contracts are traded -- the potential for large futures positions to unduly influence prices is limited. Id. at 2, 20.

Nonetheless, Rule 1.61 mandates that position limits be imposed on all futures and option contracts that are not already subject to CFTC limits. The CFTC has constructed no empirical underpinnings for this "across-the-board" approach -- attempting, instead, to extrapolate from silver market events to events in all markets -- and can thus be faulted for failing to give proper significance to the dramatic differences among the contracts it regulates.

However, even if the wisdom of imposing across-the-board limits is conceded, the wisdom of the particular limit levels selected is very much in doubt. For example, the position limit in the Chicago Mercantile Exchange's S&P 500 stock index futures contract, a very liquid, cash-settled contract, is 5,000 contracts, net long or short, in all contract months combined.[5] At the current level of the S&P 500 index, the cash value of 5,000 S&P futures contracts is approximately $600 million, which may appear to be a substantial amount. However, this number becomes less impressive when one considers the fact that a number of institutional money managers have $20-billion dollars or more under management.

The relatively low level of the position limits applicable to stock index futures are attributable, in large part, to Congressional and SEC concern about the impact stock index futures trading might have on the capital formation process -- a concern that helped to motivate a Congressionally-mandated, multi-agency study on the economic effects of futures and options trading. Because this study recently concluded that "[f]inancial futures and options markets appear to have no measurable negative implications for the formation of capital" and may actually "have enhanced liquidity in some of the underlying cash markets," this would be an appropriate time to reexamine the limits imposed in the stock index futures markets.[6] Although those limits may be adequate for certain market users, they are much too low to accommodate the portfolio management needs of many institutional money managers.

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[5] In 1985, more than 15 million S&P 500 contracts were traded, making this contract the second most actively traded futures contract. See "Volume Reflects Changing Thrust of Futures Industry," Futures Magazine at p. 48 (March 1986) [hereinafter "Futures Magazine"].

The Rule 1.61 position limit levels for other financial futures may also be suspect. For one thing, those limits were designed to pass muster with CFTC staff members, who frequently insisted that the exchanges reduce the limits they had initially proposed. For another, Rule 1.61 applies a retrospective approach to the establishment of limits, by specifying that exchange-set speculative limits "shall not exceed a level which is reasonably based on position sizes customarily held by speculative traders on such market" for a period of time selected by the exchange and must not be "extraordinarily large relative to total open positions in the contract" during that time period. In light of the retrospectiveness of this approach, it is incumbent upon the exchanges to periodically review their limits to assure that limit levels are appropriate for current market conditions. Concomitantly, because limits that are unduly conservative stand as an unnecessary barrier to the efficient utilization of the markets, the CFTC should be directed to look favorably upon exchange requests to implement limit increases.

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[6] See "A Study of the Effects on the Economy of Trading in Futures and Options," submitted to the House Committee on Agriculture, the House Committee on Energy and Commerce and the Senate Committee on Agriculture, Nutrition and Forestry by the Board of Governors of the Federal Reserve System, the CFTC and the SEC at p. I-2 (December 1984) [hereinafter the "Multi-Agency Study"].

The Need to Update the CFTC's Bona Fide Hedge Definition

Speculative position limits do not apply to positions that qualify as "bona fide hedges" within the meaning of the CFTC's definition of that term. According to that definition, bona fide hedges are futures positions that "normally represent a substitute for transactions to be made or positions to be taken at a later time in a physical marketing channel," that "are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise...." See 17 C.F.R. § 1.3(z) (emphasis added). Although this definition is somewhat complex, it essentially defines a hedge as a position assumed to reduce the risk of a change in the value of an existing, or anticipated, position in the same commodity (or a related commodity). The hedge definition dates from the 1930's and has not been amended in nearly a decade.[7]

When this rule was last amended, only a limited number of financial futures were traded -- e.g., futures on foreign currencies and GNMAs -- and trading volume in those instruments amounted to only 1.4 million contracts, or 3 percent of total futures volume.[8] In 1985, on the other hand, a wide array of financial futures were traded -- e.g., futures on certificates of deposit and a municipal bond index -- and trading volume in those financial instruments amounted to 60% of total trading volume. Indeed, trading volume in Treasury bond futures alone topped more than 40 million contracts in 1985, making that contract the most actively traded futures contract on any exchange, with futures on the S&P 500 index and Eurodollars respectively capturing second and third place. Id. See Futures Magazine, supra at p. 48. The introduction and popularity of these contracts has spurred an influx of new types of futures market participants -- including financial institutions, insurance companies, pension funds and investment companies -- and has resulted in the implementation of new types of trading strategies and techniques.

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[7] The bona fide hedge definition was originally contained in the the CEA. However, when the Congress amended the CEA in 1974, it deleted this definition from the statute and directed the CFTC to define bona fide hedges by regulation. This statutory change was motivated, in large part, by Congressional concern about the possibility that the CEA's bona fide hedge definition had become outmoded. See, e.g., S. Rep. No. 93-1131, 93d Cong., 2d Sess., 26 (1974); H.R. Rep. No. 93-975, 93d Cong., 2d Sess., 31-32 (1974). After adopting an interim regulation in October of 1975, the CFTC issued the current version of 1.3(z) in August of 1977. See 42 Fed. Reg. 42748 (August 24, 1977); 40 Fed. Reg. 48688 (Oct. 17, 1975).

[8] See B. Imel, R. Hobson and P. Tosini, "The CFTC's Hedging Definition -- Development and Contemporary Issues" at p. 33, n.22 (Oct. 1985) [hereinafter "Imel, Hobson & Tosini"].

Although these strategies and techniques are not considered "speculative" by the money managers who implement them, some of these strategies may not fit comfortably within the CFTC's bona fide hedge definition. Indeed, the introductory language of that definition itself demonstrates that the definition was written at a time when the commodities markets primarily served agricultural and mercantile users, rather than portfolio managers who are responsible for prudently maximizing returns and who must implement investment decisions involving choices among different levels of risk and anticipated returns.

The anachronistic nature of the current definition is highlighted by the fact that economically similar financial futures strategies might be treated quite differently for purposes of that definition. CFTC staff members have, for example, suggested that bona fide hedge status could be obtained for a strategy designed to "phase-in" an alteration of the composition of a fund's assets, *e.g.*, by purchasing Treasury bond futures contracts as a precursor to purchasing the actual Treasury bonds. *See* Imel, Hobson & Tosini, *supra* at 42. However, those same staff members have also suggested that bona fide hedge status could not be obtained for futures used to *temporarily* alter a fund's exposure in particular areas (*e.g.*, between equity and debt), with the intention of ultimately re-establishing the original position, rather than of converting that futures position to an equivalent cash market position. Id. at 43-44. Although each of those strategies appears to be equally appropriate for managing a portfolio's risks or maximizing its returns, the difference between their ultimate cash market consequences may currently have drastically different bona fide hedge consequences.

Similarly, bona fide hedge status may be denied to various other portfolio management strategies that can be implemented more quickly, cheaply and efficiently in the futures and options markets. The CFTC should therefore be directed to reexamine this area and to make its bona fide hedge definition more compatible with the needs and objectives of large institutional users. If this is not done, those users will look elsewhere to satisfy their risk management needs, and the full economic potential of the financial futures and options markets may never be realized.

The Need to Revise the CFTC's Aggregation Policies

For purposes of determining compliance with the applicable position limits, the CFTC requires a trader to combine all futures positions owned by him with all futures positions controlled by him. Ownership is thus given the same significance as control for position limit purposes. That is, either can serve as a basis for aggregation.[9]

The "equal billing" given to ownership stems, in part, from section 4(a) of the CEA (which makes reference to positions "held or controlled by" traders) and may have been perfectly appropriate for the futures markets of the 1930's, when ownership may have been synonymous with control. However, as those markets have grown and the types of entities participating in them have changed, it is increasingly possible for a trader to have an ownership interest in a particular account, but no control over the trading done for that account. The emphasis upon ownership -- even in the absence of actual control -- has thus become an increasingly onerous barrier to the healthy operation of the markets.

During the last decade, for example, participation in the markets through various pooled investment mechanisms has become commonplace. Indeed, by the end of 1985 more than $1 billion was invested in the markets through public and private commodity pools, and pension funds and investment companies have also become active market participants. In many instances, those pooled investment vehicles divide the responsibility for managing their assets among various money managers, each of whom operates totally independently of a fund's other advisors. Yet, under the CFTC's current aggregation policies, the positions assumed by each of those advisors for a particular fund would be added together for speculative limit purposes because those positions are owned by the same entity. Similarly, the positions assumed by a firm's subsidiary would be combined with the firm's own positions, even if the trading activities of those entities were separately controlled.

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[9] For this purpose, "ownership" is generally defined as a financial interest of 10% or more in the equity of an account.

As a result of these aggregation policies, large market users frequently find themselves bumping against limits they did not realize they were approaching. For example, a pension fund advisor who wishes to assume a long position in a particular commodity may find he is unable to do so because other advisors retained by that fund have independently determined to acquire a long position in the same commodity. The trading decisions made by those advisors may have no interconnection; yet, the CFTC would currently compel that fund to combine the positions of each of its advisors.

In my view, this is bad market economics, because it prevents money managers from fully implementing their desired investment and portfolio management policies, undercuts the advantages of employing more than one such manager and makes the commodities markets a less attractive investment forum in which to operate. Moreover, it places artificial constraints on the amount of resources an entity can commit to the commodities markets and imposes artificial limits on the growth of that entity. In the commodity pool area, for example, the "rule-of-thumb" is that a diversified pool will begin to confront limits when it reaches $40 million or $50 million in size. As a result, if the sponsors of that pool wish to expand their commodities market activities, they must either dilute the product they are offering to the public or form new entities, an alternative that is obviously more costly and less efficient than soliciting new investors for their existing pools.[10]

In my view, aggregating positions that are owned, but not in fact controlled, by the same entity is also bad regulatory policy. When traders operate independently of each other, their positions should be subject to separate limits, even if those positions are nominally owned by the same entity. In the latter regard, none of the purposes underlying speculative limits is materially furthered by requiring the aggregation of positions that are owned -- but not controlled -- by the same entity. In particular, manipulative activities cannot occur when two traders operate independently of each other, nor can the positions of those traders cause "unreasonable or unwarranted" price movements of the sort that concerned the CFTC. See p. 4, supra. Rather, the price impact of those positions would be completely random, just as the price impact of the positions taken by any other independently-functioning entities would have no concerted impact. To use an extreme example, no one would suggest that the proprietary positions of one investment banking firm should be aggregated with the proprietary positions of another investment banking firm merely because those firms might have the same futures market position (e.g., long Treasury bonds) at any particular point in time. Moreover, although aggregation on the basis of ownership may have some pertinence to the CFTC's concern about the price impact of forced liquidations, there are more efficient methods of addressing this concern -- most notably, margin and capital requirements and limits on the amount of a clearing member's exposure at the clearing house.

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[10] In this regard, it is instructive to note that certain mutual funds have assets of several billion dollars -- a fact attributable, at least in part, to their freedom from position limit concerns.

The regulatory benefits derived from making ownership sufficient, in and of itself, to require aggregation are consequently substantially outweighed by the market damage produced by this approach.[11]

For the same reasons, I believe the CFTC should expand to commodity investment advisors the aggregation policies it currently applies to the customer trading programs and discretionary accounts of futures commission merchants ("FCMs"). That is, a portfolio manager that employs a number of independent traders should not be deemed to "control" the positions assumed by those traders for different accounts if:

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[11] It should be noted, in this regard, that the SEC recently approved proposals by the securities option exchanges to require that option positions be aggregated solely on the basis of control. See 50 Fed. Reg. 50976 (December 13, 1985). Although control will be presumed to exist when a trader holds an ownership interest of 10% or more in an entity (or shares in at least 10% of the profits generated by an account), that presumption is rebuttable. See, e.g., Philadelphia Stock Exchange Rule 1001. In the securities options world, the critical factor is thus whether a person or entity, in fact, controls the trading in an account. If control does not exist, ownership of that account would not be sufficient to require aggregation.

> (i) the portfolio manager does not direct trading in those accounts;
>
> (ii) the portfolio manager maintains only such minimum control over the trading effected for those accounts as is necessary to fulfill its duty to diligently supervise; and
>
> (iii) each trading decision effected by those traders for those accounts is determined independently of all trading decisions in accounts the portfolio manager controls.

See 17 C.F.R. § 18.01. As the futures markets evolve, the types of entities to which policies of this sort should be applied have concomitantly changed. It is consequently incumbent upon the CFTC to review this area and extend its aggregation policies for FCM customer trading programs and discretionary accounts to other situations in which those policies are equally necessary and appropriate.

In short, I believe the CFTC's aggregation policies should make actual control over a particular account -- rather than apparent control, through ownership or other means -- the cornerstone of its aggregation policy. In the case of Rule 1.61 limits, regulatory action would be sufficient to more finely hone the CFTC's aggregation policies, and the CFTC should be directed to take such action as expeditiously as possible. In the case of CFTC-imposed limits, however, amendments to section 4(a) of the

CEA would be desirable to assure that the CFTC has the necessary flexibility to modernize its aggregation policies.[12]

The Need to Liberalize the CTA Definition

Finally, I would like to briefly mention one other regulatory impediment to the efficient functioning of the commodities markets that I believe should be addressed during these reauthorization hearings: the application of the CFTC's commodity trading advisor regulations. In response to a Senate Committee Report directive in 1982, the CFTC adopted Rule 4.5 to provide relief from its commodity pool operator regulations for certain regulated entities (such as insurance companies, mutual funds and pension plans) that use the futures market for certain limited purposes. However, the CFTC, to date, has not addressed the related issue of CTA registration by regulated entities that utilize the futures and options market solely in connection with their portfolio management activities.

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[12] In this regard, section 4(a)(1) currently provides that:

> In determining whether any person has exceeded such limits, the positions held and trading done by any persons directly or indirectly controlled by such person shall be included with the positions held and trading done by such person; and further, such limits upon positions and trading shall apply to positions held by, and trading done by, two or more persons acting pursuant to an express or implied agreement or understanding, the same as if the positions were held by, or trading were done by a single person.

7 U.S.C. § 4(a)(1) (emphasis added). To give the CFTC maximum flexibility in developing an appropriate aggregation policy, this language would be deleted in its entirety, or the references to "positions held" could merely be deleted. In addition, similar changes in other portions of section 4(a) might be desirable.

In my view, such an entity should receive regulatory relief comparable to that provided in Rule 4.5, because the potential benefits of registration with the CFTC are substantially outweighed by the costs of registration. That is, an appropriately regulated entity should not have to register as a CTA if it gives commodity trading advice, solely as an incident to its primary portfolio management activity, to an entity that is itself excluded or exempt from commodity pool registration. To facilitate this type of change, this Committee should include an appropriate directive in the legislative history to the 1986 Amendments to the CEA, just as the Senate Agriculture Committee spurred the adoption of Rule 4.5 by such a directive. In both instances, freedom from registration with the CFTC makes good regulatory sense and will make participation in the commodities markets a more viable and less burdensome option for certain already regulated entities.

Conclusion

In the brief span of a decade, the futures exchanges have been transformed from markets that primarily served agriculture-related businesses to markets that serve numerous components of our economic community. As this remarkable transformation has occurred, new types of participants with new types of needs, goals and trading strategies have entered the markets and the traditional ways of regulating those markets have sometimes become outmoded. The position limit, aggregation and hedge definition problems discussed above are merely examples -- albeit particularly important examples -- of the many instances in which existing regulations are no longer a "good fit" for the markets and should be altered.

A key purpose of these periodic reauthorization hearings is to assure that the CEA and the CFTC's regulations keep pace with the rapid evolution of the futures markets. I therefore believe the Congress should not forego this opportunity to facilitate position limit, aggregation policy and bona fide hedge changes that will make the commodities markets more useful during the decade to come and help to assure the long-term viability and health of those markets. If there is one thing we can all agree upon it is that the futures and options markets of the 1980's and 1990's cannot be well-regulated with a 1930's mindset.

Thank you.

national grange

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GRANGE

Edward Andersen, Master

March 12, 1986

The Honorable E de la Garza
Chairman
House Agriculture Committee
1401 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

Over the years, The National Grange has worked with the Commodity Futures Trading Commission on farmers' concerns about futures markets. The Grange is represented on the Commission's Agricultural Advisory Committee. We commend the Commission's efforts to communicate and react to the needs of the agricultural producer.

During the last four years, the Commission has fulfilled its regulatory responsibilities to the farm community and others who use the futures markets; therefore, The Grange supports the Congressional reauthorization of the Commodity Futures Trading Commission for an additional six years.

In January of 1986, the Commission voted to adopt an audit trail rule that would require exchanges to record trade execution times to the nearest minute. We believe that this new rule will be an important tool for maintaining market integrity and public confidence in futures markets.

There has been progress in the discussions between the Commission and the exchanges on the audit trail rule. However, the flexible nature of the rule, which allows each exchange to develop its own system to comply with the rule, raises several concerns about the alternative methods the industry is proposing. Whatever method is finally adopted by each exchange should produce an audit trail that has been proven to be accurate as well as one that includes data on all traders.

The Grange hopes that the Committee will proceed with the Commission's reauthorization while these discussions about how to comply with the audit trail rule continue. According to the Commission's published schedule, compliance is not required until next fall. This should leave ample time in which to work out implementation of the audit trail rule to the satisfaction of the Commission, the exchanges and the futures trading public. To delay or postpone the reauthorization of the Commodities Futures Trading Commission would not be in the best interest of agricultural producers.

Thank you for your consideration of these views.

Sincerely,

Edward Andersen

Edward Andersen
National Master

EA/lwh

cc: House Agriculture Committee

LAW OFFICES
FISHMAN MERRICK & PERLMAN, P.C.

STATEMENT OF GERALD L. FISHMAN IN FAVOR OF RETAINING AUTOMATIC STAY OF NATIONAL FUTURES ASSOCIATION ACTION PENDING COMMODITY FUTURES TRADING COMMISSION REVIEW

The National Futures Association ("NFA") was organized under Section 17 of the Commodity Exchange Act (the "Act") and many of the duties delegated to the Commodity Futures Trading Commission ("CFTC") by the Act have been redelegated to the NFA through the vehicle of Section 17, including the enactment of regulations to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade and the creation of procedures to enforce these rules and discipline members for their violation.

To maintain some control over this broad delegation of the CFTC's power, Section 17(h) provides for the review by the CFTC of all disciplinary action taken by a national futures association (including the denial, suspension or termination of membership) upon the application of the aggrieved party or on the Commission's own motion. Under current law, an aggrieved party's application for review of an NFA decision or the CFTC's own institution of a review operates as an automatic stay to the enforcement of the NFA action. The CFTC may subsequently lift the stay after notice to the parties and an opportunity for hearing on the question of the stay.

Section 301 of Senate Bill 2045 would amend Section 17(h) to create an opposite result, so that the application by a party for review to the CFTC of an NFA decision or the institution by the CFTC of a review on its own motion would not operate as a stay unless the CFTC otherwise ordered, after a hearing which may consist solely of the submission of affidavits *or* oral argument.

The proposed amendment should not be enacted for two interrelated reasons. First, the additional autonomy granted to the NFA by the proposed provision, in effect, creates an improper delegation of the CFTC's duties under the Act to a private association. Second, the elimination of the safeguards now present in Section 17(h) would deprive those aggrieved by NFA proceedings of the due process required by the Act and the Constitution.

A review of the legislative history surrounding the enactment of current Section 17 demonstrates that the principal argument against its enactment was that it was an impermissible delegation of the CFTC's responsibilities under the Act, to monitor the commodities field, to a private association. Although the current trend, often mandated by the unmanageable work load borne by administrative agencies, is to delegate more responsibility to the "self-regulatory" sector, the Constitution requires that an administrative agency maintain certain control of the duties that it delegates to other bodies. As *currently* in force, Section 17(h) maintains that balance.

Although the NFA is free to promulgate rules and enforce compliance thereof, before an NFA member is deprived of NFA membership or is disciplined for violation of an NFA rule, the individual has the opportunity for a hearing before the CFTC which also automatically stays implementation of the NFA action. The automatic stay pending CFTC review is mandated by the Act, which requires a hearing to be held by the CFTC before an individual can be disciplined or deprived of trading privileges.

The ultimate responsibility for the creation of rules to monitor the commodities field and their enforcement is vested in the CFTC. Whether those rules be promulgated by the CFTC or the NFA the CFTC is ultimately responsible for their enforcement. Although certain regulatory duties have been delegated to the NFA, any decision of the NFA must be reviewable by the CFTC *before* that decision deprives an individual of NFA membership or subjects that individual to disciplinary measures. This is the very essence of the automatic stay mechanism. The proposed amendment would erode the control the CFTC has over NFA disciplinary action to an impermissible level.

Although the proposed amendment will effect all NFA proceedings, it is especially troublesome in light of the NFA's Member or Associate Responsibility Actions ("MRAs") which provide for ex parte actions including suspension of an individual's NFA membership. Neither the NFA nor the CFTC can deprive an individual of trading rights without the opportunity for a hearing, and the present scheme affords that opportunity to an aggrieved NFA member by automatically staying the enforcement of NFA ex parte proceeding upon the member's application for CFTC review. The proposed amendment would eliminate this safeguard, and allow for the summary deprivation by the NFA of an NFA member's livelihood without a *prior* hearing at any level.

The ex parte decisions provided for by the NFA's MRAs also raise the issue of due process. At the very minimum, due process requires that an individual be given an opportunity for hearing before being deprived of property. Although the NFA is a private association, it has achieved the status of a quasi-governmental agency due to its registration with the CFTC and the broad delegation of power it has received from the CFTC, and, thus, the requirements of due process apply to its activities.

Clearly, the NFA must afford an individual some measure of due process before depriving him of his membership or taking disciplinary actions against him. At a minimum, due process requires that a member be given an opportunity to be heard before he is disciplined or deprived of trading privileges. As enacted, Section 17(h) does so by allowing for CFTC review of ex parte actions of the NFA, which include a hearing, which automatically stays implementation of the NFA action. The proposed scheme would jeopardize an aggrieved member's due process rights by allowing a summary action of the NFA to deprive him of membership or other property before a hearing is held by the NFA or reviewed by the CFTC.

Finally, little if any is to be gained by the proposed amendment. A CFTC hearing on whether or not to stay an NFA decision pending CFTC review can be accomplished in less than ten (10) days. It is difficult to see how, in the face of the considerations enumerated above, this 10 day stay of the NFA's proceedings could be in any way detrimental to the NFA's enforcement scheme.

As the proposed Amendment to Section 17(h) of the Act, in effect, would represent an impermissible delegation of the CFTC's power to the NFA and as it could conceivably deprive NFA members of the due process required by the Commodity Exchange Act and the Constitution we respectfully submit that such act not be passed.

Respectfully submitted,

March, 1986

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March 13, 1986

Honorable E. de la Garza, Chairman
Committee on Agriculture
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

On behalf of the soybean farmer members of the American Soybean Association (ASA), I offer comment on the reauthorization of the Commodity Futures Trading Commission (CFTC). I ask that this letter be included in the record of hearings conducted by the Committee.

ASA strongly supports reauthorization of the CFTC as an independent regulatory agency for six years. We believe the CFTC deserves reauthorization as the agency charged with regulating the trading of commodity futures based on its record since it was last reauthorized in 1982. While the CFTC has not ended all problems and concerns associated with commodity futures, we believe it has made substantial progress that will be continued after reauthorization.

ASA also supports CFTC's efforts to require exchanges to develop a system to provide a provable audit trail of all exchange transactions. ASA supports granting exchanges flexibility in choosing a system which will comply with the CFTC's audit trial requirements. However, we believe all systems implemented by exchanges must be demonstrated to allow for an accurate and complete audit trail to be easily determined.

ASA is aware the CFTC and the various commodity futures exchanges are currently involved in discussions about various audit trail proposals. We support the discussions and hope they can continue outside the legislative reauthorization process.

Sincerely,

George Fluegel

George Fluegel
President

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NATIONAL
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ORGANIZATION

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President
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Director
Washington Office
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March 17, 1966
Page Two

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Sincerely,

Chuck

Charles P. [illegible]
Director
[illegible] Office

NATIONAL
GRAIN & FEED
ASSOCIATION

March 11, 1986

The Honorable Ed Jones
Chairman
Subcommittee on Conservation,
  Credit and Rural Development
1336 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

The National Grain and Feed Association respectfully requests that this statement be included in the subcommittee record as part of the consideration of the reauthorization of the Commodity Futures Trading Act. As the Members of the Association rely heavily upon the futures markets to hedge purchases and sales of grain and/or grain products, we place great importance on the reauthorization of this Act.

The membership of the National Grain and Feed Association encompasses 1,200 companies nationwide and is comprised of every segment of the grain and feed industries -- country elevators, terminal elevators, merchandisers, exporters, feed manufacturers and dealers, and primary food processors (e.g. grain millers and oilseed processors).

The contemporary concept of futures trading -- that which is conducted on organized commodity markets under rules and regulations promulgated by the exchanges -- had its practical beginning in Chicago more than 100 years ago. It was the grain trade that pioneered these efforts and basic field crops -- grains -- were the commodities first traded on these exchanges. In the ensuing decades futures trading has expanded to other commodity sectors and commodity futures markets have proved to be efficient and viable marketing mechanisms, not only for the agricultural industry but for other segments of the nation's economy as well. Futures markets have provided a valuable, open, competitive forum in which the vitally important price discovery process can take place in a free market environment.

The U.S. grain industry is proud of the role it played in the development of commodity futures markets. It is pleased with the expansion that has transpired in the futures industry. The National Grain and Feed Association believes it has been a constructive, positive force during this development and growth process. It is a matter of record that this Association has been a responsible cooperative counselor to the Congress and other branches of government, and has aided government as it has considered legislation and regulatory proposals pertaining to futures markets.

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Continuation of viable futures markets is critical to a competitive and efficient marketplace for agriculture. The price discovery mechanism provided by the futures markets benefit the entire nations' economy as it ensures fair prices are offered to both producers and consumers alike. Just as important to the smooth functioning of a competitive market place is the risk management mechanism provided by futures and options markets. Without the opportunity to shift risks via these markets, commercial interests would be unable and/or unwilling to offer many of the marketing services available today. And the cost of providing marketing services would be substantially greater in the absence of futures markets. Futures markets are truly the corner-tone of an efficient marketplace.

The National Grain and Feed Association believes that the Commodity Futures Trading Act of 1982 has served the industry well. We further believe that the current legislative extension process should be confined to management-type improvements in the existing law rather than the adoption of sweeping new legislation.

This Association strongly recommends that the regulatory agency (the Commodity Futures Trading Commission) continues to be an independent agency. We believe, as we have believed since the creation of the CFTC, that all futures markets should be regulated by an independent regulatory body. The National Grain and Feed Association recommends that no substantive changes be made in the Act as it relates to the jurisdiction of the CFTC pertaining to futures markets.

While not under active consideration, the issue of margin-setting authority being vested in one or more government agencies remains a primary concern for our industry. It is our firm belief that margins on futures contracts should continue to come under the sole purview of the individual futures markets.

There seems to be continuing confusion about futures market margins that cause some to believe that there is a great similarity between margins on securities and margins on futures contracts. The purpose of margins in securities markets is clearly stated in the Securities and Exchange Act of 1934 whereby margin refers to the required level of down payment on credit purchases of securities.

In contrast, the purchase and sale of a futures contract on margin is not a credit transaction. The only capital asset involved is the commodity itself which can only be used after delivery occurs at which time ownership is financed through otherwise established credit facilities not under the control of commodity exchanges, chiefly the banking system. Since no title is conveyed prior to delivery and no loan is extended, no credit is involved in a futures transaction, hence the word "margin" has an entirely different meaning in this context, and the purpose of margins is different.

The purpose of margins in futures markets is to ensure the financial integrity of all futures contracts trading on these exchanges. The purpose of margins in securities markets is to serve as a down payment. The function of securities markets is to transfer title, from one owner of a security to another. The function of futures markets is not to transfer title, rather it is to transfer price risk. Recognition of the differences in function between these institutions should help in understanding the differences between them regarding margin concepts.

We do not believe any government agency, no matter how enlightened or well-intentioned, possesses the capability to manage the margin responsibilities for futures markets. We do not believe any government agency could be sufficiently responsive to changes in margin levels that frequently must be effected in an environment of fast-breaking changes that necessitate rapid, immediately implemented, decisions. In our judgment, only the individual exchanges have the capability to deal with the logistical realities of margin-setting responsibilities regardless of the underlying commodity.

Under the current Act and regulations, cash forward contracting is not regulated by CFTC. Encumbering the efficient grain marketplace with federal regulations would only distort the responsive nature of the grain market's purchaser and seller needs. The National Grain and Feed Association strongly recommends that no added provisions for the regulation of cash commodity forward-contracting be included in the extension of this legislation.

One of the most significant changes in futures exchange activity authorized by the Commodity Futures Trading Act of 1982 was the pilot program for agricultural options. This program has been highly successful. Although limited in scope, options contracts for agricultural commodities have provided producers and commercial hedgers many new alternatives for hedging their risks.

Producers, commodity buyers, elevator operators, processors and exporters have just begun to realize the vast potential uses of options, the innovations and opportunities they will bring to marketing and purchasing commodities. As price supports offered in government programs are adjusted to allow the U.S. to compete in export markets, producers will find options markets provide them with new alternatives for developing production and marketing strategies. Options, offering a guarantee of a miniumum price without limitation on potential gains from market rallies, may become increasingly attractive to producers and hedgers during coming growing seasons.

Based upon results of the pilot program in options, we would support an expansion of the current program. If the pilot program continues its current degree of success, full authorization for options trading should be seriously considered.

The application of options in commercial channels has had an impact on cash grain contracting resulting in an expansion of the types of cash contracts offered to producers by buyers. Through these new cash contracts, additional producers have realized benefits from the new options markets. In an interpretative statement published in the September 30, 1985 Federal Register, the CFTC confirmed its view that these new cash contracts were forward cash contracts and not subject to CFTC jurisdiction. We agree with this conclusion and commend the CFTC for clarifying its viewpoint to industry.

As a matter of legislative and regulatory responsibility and accountability, we recommend that the Commodity Exchange Act, as amended, be extended for a period of six years.

The National Grain and Feed Association desires to be helpful to the Congress as it considers this reauthorization legislation. Please do not hesitate to contact the National Association regarding any questions whatsoever your Committee may have on this overall subject.

Sincerely,

Tom Geldermann
BB

Tom Geldermann
Chairman
Commodity Exchange Committee

TG:lp

STATEMENT OF THE INTERMARKET CLEARING CORPORATION
BEFORE THE SUBCOMMITTEE ON CONSERVATION, CREDIT, AND RURAL DEVELOPMENT
COMMITTEE ON AGRICULTURE
U.S. HOUSE OF REPRESENTATIVES

APRIL 15, 1986

The Subcommittee currently has under consideration a number of proposed amendments to the Commodity Exchange Act (the "CEA") in connection with the reauthorization of the Commodity Futures Trading Commission (the "CFTC"). The Intermarket Clearing Corporation ("ICC") urges that there be included among those amendments provisions that would clarify the CFTC's authority to permit "cross-margining" of positions in securities and commodities products relating to similar underlying assets.

This statement begins with some background information regarding ICC; then discusses cross-margining and its benefits; identifies certain potential impediments to cross-margining in the present language of the CEA; and suggests ways of eliminating those impediments.

The Intermarket Clearing Corporation

ICC is the commodity clearing subsidiary of The Options Clearing Corporation ("OCC").* ICC, which commenced operations in 1985, presently serves as the clearinghouse for commodity futures and commodity options transactions on the New York Futures Exchange, the AMEX Commodities Corporation, and the Philadelphia Board of Trade.

As its name suggests, ICC was formed with a view towards providing common clearing services for multiple markets. By offering centralized clearing for trades executed in multiple commodities markets, ICC believes that it can significantly reduce the commodities industry's back-office costs, provide an enhanced level of service, and simplify surveillance of multi-market positions.

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*OCC is the issuer and guarantor of the standardized options on stocks and other underlying assets traded in the securities markets.

An equally important part of ICC's charter was to develop a system for margining mixed positions in securities and commodities products relating to the same or similar underlying assets — for example, the stock index options traded on securities exchanges and the stock index futures traded on commodity exchanges. This is commonly referred to as "cross-margining."

Cross-Margining

Margin (referred to as "initial margin" in the commodities markets) is the security deposit that a customer who enters into a futures contract or writes an option must make with his broker to guarantee performance of his obligations. The broker carrying the customer's position must in turn deposit margin with the exchange's clearinghouse to secure performance of the broker's obligations. The amount of margin required for a particular position or combination of positions depends on the degree of risk. In both the securities and the commodities markets, if a customer has a "hedged" position that limits his potential loss no matter which way the market moves, margin requirements at both the broker and the clearinghouse level are substantially lower than if the position were unhedged.

In recent years, securities products (in the form of standardized options) and commodities products (in the form of both options and futures contracts) have come to be traded on the same underlying assets. Such assets include stock indices, foreign currencies, and U.S. government securities. This creates opportunities for intermarket hedging. For example, a trader might hedge a short position in index options on the Chicago Board Options Exchange with a long position in index futures on the Chicago Mercantile Exchange.

Because securities exchanges and commodity exchanges have different clearing organizations, each "leg" of an intermarket hedge position must currently be carried with a different clearinghouse. Each clearinghouse "sees" only one leg of the position, and margins that leg as if the other risk-reducing leg did not exist. As a result, firms carrying positions for intermarket hedgers must meet substantially higher clearinghouse margin requirements than are warranted by the risk of their positions, taken as a whole. In turn, the hedgers themselves are subjected to unnecessarily high margin requirements by their brokers. This creates unnecessary costs for market participants and tends to discourage intermarket hedging and arbitrage, which are economically desirable activities.

"Cross-margining" refers to the process of margining both legs of an intermarket hedge as a unitary position and recognizing the limited risk of the position through reduced margin requirements. At present, there are both structural and regulatory obstacles to cross-margining. The structural obstacles result from the separate development of the securities and commodities markets, each with their own clearing systems. The regulatory obstacles result from the fact that the separate regulatory schemes for securities and commodities products established in the Securities Exchange Act of 1934 (the "1934 Act") and the CEA were enacted when there was not the commonality between the two markets that currently exists.

ICC has addressed the structural obstacles by devising a system under which positions in both securities and commodities products could be carried with a single clearing organization. This would enable clearing organizations to offer cross-margining to their members, who would in turn be able to offer cross-margining to their customers.

The regulatory obstacles arise in part out of the segregation provisions of the CEA, which do not contemplate the possibility that positions in securities products, such as standardized options, might be carried in the same accounts as commodity futures contracts and commodity options. In addition, the bankruptcy and insolvency provisions applicable to securities and commodities brokers presume that positions in securities products and commodities products will be carried in separate accounts, which could be administered separately in the event of the insolvency of a broker carrying positions in both types of products.

The CFTC's rulemaking authority under existing provisions of the CEA may be sufficient to enable it to surmount these regulatory obstacles and permit cross-margining. ICC currently has on file with the CFTC a petition for rulemaking, which, if acted upon, would permit ICC to offer cross-margining. However, ICC recognizes that its petition may raise questions as to the scope of the CFTC's authority. Reauthorization offers the opportunity for Congress to adopt technical amendments to the CEA that would eliminate those questions and enable the CFTC to deal with the merits of cross-margining rather than with technical issues of law.

Benefits of Cross-Margining

The most obvious benefit of cross-margining is that it would materially decrease the cost of maintaining intermarket hedges by reducing the amount of margin required to be deposited on hedged positions. This would eliminate a present deterrent to intermarket hedging and arbitrage, which can contribute significantly to the depth and liquidity of the markets involved and the efficiency of intermarket pricing.

Cross-margining would also enhance the security of clearing systems. The key role played by clearing organizations in maintaining the integrity of the nation's securities and commodities markets has previously been recognized by Congress. The Bankruptcy Code, for example, provides special protections to clearing organizations.* Cross-margining would provide clearing organizations with more effective safeguards against member defaults by reducing their reliance on fixed-value margin. The inherent weakness of margin systems is that they utilize cash or other assets of fixed value to cover obligations whose liquidation cost may fluctuate substantially from day to day. Although a properly constructed cash margin system should provide a sufficient cushion to protect the clearing organization against reasonably foreseeable changes in the cost of liquidating members' positions, no workable margin system based on cash or other fixed-value assets can be expected to protect fully against extraordinary price movements. In contrast, where an obligation is fully hedged by a position on the other side of the market, any increase in the cost of liquidating the hedged obligation should be offset by a corresponding increase in the value of the hedge. Concentrating both legs of intermarket hedge positions in a single clearing organization would thus reduce the overall risk to the securities/commodities clearing system in the event of a clearing firm's default.

Cross-margining would also reduce clearing organizations' surveillance problems. A clearing organization attempting to monitor its risk exposure often sees only part of the picture. A clearing member may be carrying positions in related products with multiple clearing organizations, each unaware — at least on a moment-to-moment basis — of the positions carried with the others. While this problem can be partially addressed through better communications among clearing organizations, its scope would be reduced to the extent that clearing firms were given a financial incentive to carry positions in economically similar products with a single clearing organization. The potential cost savings resulting from cross-margining would provide that incentive.

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*See, e.g., 11 U.S.C. §§362(b)(6), 546(e), 548(d)(2)(B), 555, and 556.

Cross-margining would also eliminate potential settlement problems associated with the maintenance of large intermarket hedge positions. If a firm carries the two legs of an intermarket hedge with different clearing organizations, a sharp price movement in the underlying asset may generate obligations to one clearing organization that cannot be met except out of funds receivable from the other. Even if daily settlements at the two clearing organizations occur simultaneously, which may not always be the case, the time required to transfer funds from one to the other could lead to temporary settlement defaults, possibly affecting a clearing organization's own ability to make timely settlement. If both legs of the hedge could be carried with the same clearing organization, that problem would no longer exist.

In short, cross-margining offers substantial cost and net capital savings to market participants, the potential for greater liquidity and depth in the markets involved, and greater protection for clearing organizations.

Potential Impediments to Cross-Margining

The convergence between the types of products traded in the commodities markets and the securities markets that gives rise to the need and opportunity for cross-margining has taken place within the past few years, and was not contemplated when most of the present CEA was originally enacted. As an unintended result, there are a few provisions in the CEA that, at worst, could be interpreted as preventing the CFTC from permitting cross-margining, or, at best, could create uncertainties if applied in an environment where cross-margining was permitted.* These provisions are found in Section 4d of the CEA, which concerns the segregation of customer funds held by a futures commission merchant, and Section 20 of the CEA, which gives the CFTC authority to include or exclude specified property from "customer property" as defined in the commodity broker subchapter of the Bankruptcy Code.

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*Although the implementation of cross-margining may require regulatory relief from the Securities and Exchange Commission, the 1934 Act, unlike the CEA, does not appear to contain any potential impediments to cross-margining.

In the case of Section 4d, although ICC believes that in its present form that Section allows the CFTC sufficient latitude to adopt rules permitting cross-margining, arguments may be made to the contrary. Accordingly, we are proposing an amendment to that Section that would eliminate the uncertainties that are presented by the existing provisions and would permit the CFTC to deal with cross-margining on its merits, with no question as to its statutory authority to do so. In the case of Section 20, the present provision gives the CFTC authority to determine whether specific property should be included within "customer property" for purposes of the commodity broker subchapter of the Bankruptcy Code. However, since a cross-margined account containing both commodities and securities positions could be subject to both the Bankruptcy Code and the Securities Investor Protection Act of 1970 ("SIPA"), it would seem appropriate that the Securities Investor Protection Corporation ("SIPC") should be given similar authority to allocate property, so that property held in cross-margined accounts would not be subject to conflicting claims under the Bankruptcy Code and SIPA.

Potential Amendments

Attached to this statement are proposed amendments to Sections 4d and 20 of the CEA that ICC believes would resolve the uncertainties discussed above. The proposed amendments would not mandate cross-margining. Rather, they would eliminate the uncertainties and would leave the CFTC free to specify the terms and conditions under which cross-margining would be permitted.

Although the language of the proposed amendments is somewhat lengthy, the purposes sought to be achieved are simple. The proposed amendment to Section 4d would add a new paragraph expressly permitting funds received by an FCM in connection with customers' commodity transactions to be commingled at the clearinghouse level, subject to such terms as the CFTC might prescribe, with funds received in connection with customers' transactions in SEC-regulated options. The amendment would permit the commingled funds to be used to discharge obligations arising out of customers' transactions in SEC-regulated options as well as in commodity products. Because the clearinghouse would be carrying positions in securities as well as commodity products, the amendment would require a clearinghouse to register as a clearing agency under Section 17A of the 1934 Act as a condition to offering cross-margining.

The proposed amendment to Section 20 of the CEA would avoid overlaps among the various definitions of "customer property" in the Bankruptcy Code and SIPA, as applied to assets in cross-margining accounts, by authorizing the CFTC (together with SIPC, as to cases under its jurisdiction) to adopt rules allocating such assets between securities customer property and commodity customer property. In cases where SIPC did not have jurisdiction, only the CFTC's rules would apply. To avoid potential conflicts in cases where the rules of both the CFTC and SIPC applied, the proposed amendment would require the two organizations to cooperate to ensure that their rules were mutually consistent and became effective simultaneously. (SIPC has reviewed the proposed amendment to Section 20 and has advised ICC that it has no objection to it.)

Conclusion

Cross-margining of positions in securities and commodities products relating to the same or similar underlying assets makes eminent good sense from an economic standpoint, and offers significant benefits to both the securities and the commodities markets. Were it not for an accident of history—the separate development of the securities and commodities markets and their regulatory structures — cross-margining would undoubtedly exist today.

The amendments proposed herein are modest and should be non-controversial. Their only purpose is to eliminate any potential statutory impediments to cross-margining, leaving the CFTC free to evaluate cross-margining on its merits.

(Attachments follow:)

Proposed Amendments to Sections 4d and 2
of the Commodity Exchange Act

Doc 5
Doc 27

SEC. ____. Section 4d of the Commodity Exchang

is amended by inserting immediately after paragraph (2) thereof

"Notwithstanding the foregoing provisions of this section, money, securities, and property of the customers of a futures commission merchant may, in accordance with such terms as the Commission may prescribe by rule, regulation, or order, be commingled and deposited in an account or accounts maintained with any bank or trust company or with any clearinghouse organization of a contract market that is registered as a clearing agency under the Securities Exchange Act of 1934, with any other money, securities, and property received by such futures commission merchant to margin, guarantee, or secure the trades or contracts of such customers in standardized securities options, or accruing to such customers as a result of such trades or contracts, and such share of the commingled money, securities, and property as in the normal course of business shall be necessary to margin, guarantee, secure, transfer, adjust, or settle the trades or contracts of such customers cleared through such clearinghouse organization (whether in contracts subject to the jurisdiction of the Commission or in standardized securities options), or resulting market positions, may be withdrawn and applied to such purposes, including the payment of any charges lawfully accruing in connection with such trades and contracts. As used in this paragraph, the term 'standardized securities options' shall mean option contracts traded on a national securities exchange or through the facilities of a registered national securities association pursuant to the provisions of the Securities Exchange Act of 1934.".

Disc. 8
Doc 3

SEC. ____. Section 20 of the Commodity Exchange is amended by —

(1) inserting a new subsection (b) reading as follows:

"(b) Notwithstanding title 11 of the United States Code and the Securities Investor Protection Act of 1970, with respect to any 'debtor' as defined either in title 11 of the United States Code or in the Securities Investor Protection Act of 1970 that is both a commodity broker and a stockbroker, the Commission and SIPC may each provide, by rule or regulation, for the allocation, as between 'customer property' as defined in subchapter III of chapter 7 of title 11 of the United States Code, 'customer property' as defined in subchapter IV of said chapter, and 'customer property' as defined in the Securities Investor Protection Act of 1970, of cash, securities, or other property, or proceeds thereof, held by or for the account of the debtor, from or for any account of a customer that includes or included positions both in commodity contracts and in standardized securities options; provided, however, that any rules adopted by SIPC under this subsection shall apply only to a 'debtor' as defined in the Securities Investor Protection Act of 1970, and shall provide for the allocation of such cash, securities, other property, or proceeds only as between 'customer property' as defined in subchapter IV of chapter 7 of title 11 of the United States Code and 'customer property' as defined in the Securities Investor Protection Act of 1970. In formulating rules or regulations pursuant to this subsection, the Commission and SIPC shall cooperate with each other to ensure that such rules and regulations are mutually consistent and become effective simultaneously."; and

(2) redesignating subsection (b) thereof as subsection (c) thereof and amending that subsection to read as follows:

"(c) As used in this section, the terms 'commodity broker', 'commodity contract', and 'customer' have the meanings assigned such terms for the purposes of subchapter IV of chapter 7 of title 11 of the United States Code; the term 'stockbroker' has the meaning assigned such term for the purposes of title 11 of the United States Code; the term 'SIPC' means the Securities Investor Protection Corporation; and the term 'standardized securities options' has the meaning assigned such term for the purposes of section 4d of this Act. As used in subsection (a) of this section, the terms 'customer property', 'member property', 'net equity', and 'security' have the meanings assigned such terms for the purposes of subchapter IV of chapter 7 of title 11 of the United States Code.

American Bar Association

April [illegible], 1986

The Honorable Ed Jones
Chairman, Subcommittee on Conservation,
 Credit and Rural Development
Committee on Agriculture
United States House of Representatives
Washington, D.C. 20515

Dear Chairman Jones:

The Section of Corporation, Banking and Business Law of the American Bar Association respectfully submits the attached Statement on the bill recently submitted by the Commodity Futures Trading Commission to amend the Commodity Exchange Act. The Section requests that the Statement be included in the record of the hearings on the bill held by the Subcommittee, and that the Statement be considered in the Subcommittee's deliberations on the bill.

The Statement was drafted by members of the Committee on Futures Regulation of the Section, and is being presented on behalf of the Section. The Statement has not been approved by the House of Delegates or the Board of Governors of the American Bar Association, and, accordingly, should not be construed as representing the position of the American Bar Association.

I, on behalf of the Section, urge your careful consideration of the Statement because it has been carefully prepared by knowledgeable practitioners in the area of futures law. If you or any members of your Subcommittee desire further information about the issues addressed in the Statement, members of the Committee on Futures Regulation would be pleased to make themselves available to the Subcommittee.

Very truly yours,

Frank R. Morris, Jr.
Frank R. Morris, Jr., Chairman

FRM/skp
Enclosure
cc: Allen E. Brennecke, Esq., Chairman, ABA House of
 Delegates
 William H. Neukom, Esq., ABA Secretary
 Robert D. Evans, Esq., Director, ABA Governmental
 Affairs Group
 Barbara H. Jarr, Assistant Staff Director, ABA
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SECTION OF CORPORATION, BANKING AND BUSINESS LAW
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WRITTEN STATEMENT OF THE SECTION OF CORPORATION, BANKING AND BUSINESS LAW REGARDING THE CFTC'S 1986 REAUTHORIZATION BILL

This statement is being submitted on behalf of the Section of Corporation, Banking and Business Law of the American Bar Association. It was drafted by members of the Committee on Futures Regulation of that Section. These views are being presented only on behalf of the Section. They have not been approved by the House of Delegates or the Board of Governors of the American Bar Association, and, accordingly, should not be construed as representing the position of the American Bar Association.

The Committee on Futures Regulation of the Section of Corporation, Banking and Business Law has approximately 350 regular members, who are lawyers practicing throughout the country, in both the private and public sectors. In addition we have about 50 associates who are economists, exchange administrators, academicians, and others who are involved one way or another in the workings of the commodity markets.

Members of the Committee have reviewed the Commission's proposed legislative changes and offer the following observations in order to clarify the full impact, and in some instances, unintended, significant changes that would occur if certain provisions were enacted as drafted. Our views and clarifications are addressed to four of the Commission's proposed amendments to the Commodity Exchange Act (the "Act"), where issues of a fundamentally legal nature predominate. These clarifications involve the proposed amendment to the anti-fraud provision contained in Section 4b of the Act; the amendment to Section 6(b) which would permit extraterritorial service of investigative subpoenas on foreign nationals in foreign countries; the amendment to grant the Commission authority to request ex parte appointment of temporary receivers for companies; and finally, a new provision which would require judicial review of Commission actions only before the Courts of Appeals where the aggrieved party resides or has its principal place of business.

Amendment to Section 4b

Section 101 of the bill would amend Section 4b of the Act by deleting the words "on or subject to the rules of any contract market" after the words "any contract of sale of any commodity for future delivery, made, or to be made,". The proposal is unnecessarily broad in scope to accomplish the result intended by the Commission and could result in a significant unintended extension of the Act to completely foreign transactions.

Mere deletion of the phrase "on or subject to the rules of any contract market" from Section 4b of the Act would allow the Commission to regulate wholly foreign futures contracts, in direct contradiction to Congressional intent as evidenced by legislative history and by Section 4(b) of the Act which was enacted during the reauthorization in 1982. Such an amendment undoubtedly would confer a private right of action under Section 22(a) of the Act on foreign parties to commodity futures contracts made, executed and settled completely on foreign markets. The legislative history of Section 22 suggests that Congress did not intend to grant such a right to foreign parties in connection with contracts on foreign markets. The proposed amendment, therefore, would allow into United States courts an influx of cases which have no relation to American investors or American contract markets.

The Commission's objective of clarifying that Section 4b is applicable to illegal, off-exchange futures transactions in the United States can be met without inappropriately expanding the scope of the application of the provision and unwittingly opening the courts to cases with no connection to the United States. To remedy this unintended result and still achieve the Commission's objectives we suggest the following. After deleting the phrase as proposed by the Commission, the words "in the United States" should be added after the words "any contract of sale of any commodity for future delivery, made, or to be made,". The phrase would then read: "It shall be unlawful . . . (2) for any person, in or in connection with any order to make, or the making of, any contract of sale of any commodity for future delivery, made, or to be made, in the United States for or on behalf of any other person . . . ." This addition would make Section 4b applicable to all illegal off-exchange futures contracts made or to be made in the United States, but would exclude foreign transactions with which the Act and the United States courts should not be concerned.

The legislative history of the Act, in light of the overall regulatory scheme, indicates that Congress did not intend to regulate wholly foreign transactions. *See de Atucha* v. *Commodity Exchange, Inc.*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,580 at 30,504 (S.D.N.Y. 1985). ("We have found nothing in the legislative history which suggests that the legislature intended the CEA to confer a cause of action upon foreign litigants who traded exclusively on foreign markets."). In Section 4(b), Congress explicitly authorized the Commission to regulate the offer and sale of futures contracts made on foreign exchanges by any person *located* in the United States. The House Report states that the purpose of this section is to "protect the interests of United States residents. . . ." 1982 U.S. Code Cong. & Ad. News at 3934.

The district court in *de Atucha* reasoned that "[i]n view of Congress' explicit recognition that the domestic offer and sales of foreign commodities contracts is within the scope of the CEA, its silence with respect to wholly foreign transactions is strong evidence that such transactions were not intended to be and are not regulated under the Act."

Adoption of the Commission's proposed amendment, therefore, would result in the paradox that the statute, by its terms, would allow a cause of action by foreign plaintiffs in regard to foreign contracts, while the legislative history of the Act would suggest the contrary results.

On the other hand, adoption of the amendment proposed herein would address the Commission's concerns while still requiring those who utilize United States courts to demonstrate "a significant domestic element." *Kleinberg* v. *Baer Stearns & Co.*, 82 Civil 2531 (S.D.N.Y. 1985), available on Lexis in GenFed library.

Extraterritorial Service of Subpoenas

Section 102 of the bill would amend Section 6(b) of the Act to permit the extraterritorial service of a subpoena upon any person and would thus permit the service of a CFTC subpoena upon a foreign national and foreign country. In the event that such person failed to comply with the subpoena, an enforcement order could be issued by a U.S. court, and failure to obey such an order would be punishable as contempt.

The Section is in complete agreement with the Commission and its desire to obtain information concerning all participants in the United States futures markets and appreciates its frustration in not being able to obtain information from foreign nationals. However, we believe means, other than that proposed, must be utilized.

Service of a subpoena pursuant to this provision outside the United States on a foreign national 1/ we believe would violate international law and in some instances might violate the U.S. Constitution as well. It is a well-established and respected principle of international law that a state may not exercise its enforcement jurisdiction -- including the service of subpoenas -- against aliens within the sovereign territory of another state. 2/ This principle has been cited with approval by

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1/ While it has been held that a subpoena may be served on a U.S. citizen located in a foreign country, Blackmer v. U.S., 284 U.S. 421, 436-38 (1932); see also 28 U.S.C. § 1783 (providing for foreign service of a subpoena pursuant to Rule 45 of the Federal Rules of Civil Procedure, but limited by its terms to U.S. citizens and residents), it has been recognized that even this less intrusive exercise of extraterritorial power must be handled extremely delicately in light of the sovereign interests of other nations. A Congressional report characterized the extraterritorial issuance of subpoenas to U.S. persons in civil cases as an "extraordinary subpoena power" to be used only in the presence of a "compelling reason". 1964 U.S. Code Cong. & Ad. News 3782, 3791.

2/ Service of a subpoena is an act of enforcement jurisdiction since failure to comply with its terms is ultimately punishable by court sanctions. Enforcement jurisdiction, (Footnote Continued) a number of U.S. courts and academic commentators. 3/ In CFTC v. Nahas, 738 F.2d 487 (D.C. Cir. 1984), the U.S. Court of Appeals for the D.C. Circuit ruled that the CFTC has no statutory authority to serve a subpoena on a Brazilian national in Brazil. In doing so, it stated that such service:

> "would seriously impinge on principles of international law. 'When compulsory process is served [abroad] . . . the act of service itself constitutes an exercise of one nation's sovereignty within the territory of another sovereign. Such an exercise constitutes a violation of international law.'" Id. at 493-94.

(Footnote Continued)
which refers to a state's power to punish violations of its laws and regulations, must be distinguished from prescriptive jurisdiction, the power to regulate conduct. While U.S. prescriptive jurisdiction exists over "acts done outside a jurisdiction, but intended to produce and producing detrimental effects within it," Strassheim v. Daily, 221 U.S. 280, 285 (1911) (J. Holmes), and over U.S. nationals wherever located, Blackmer, v. U.S., 284 U.S. 421, 436-38 (1932), enforcement jurisdiction continues to be, with few exceptions, strictly territorial. See Extraterritorial Jursidiction of U.S. Courts Regarding the Use of Subpoenas Duces Tecum to Obtain Discovery in Transnational Litigation: The Search for a Limiting Principle, 16 N.Y.U.J. of Int'l L. and Pol. 1135, 1154-55 (1984).

3/ See, e.g., Pain v. United Technologies, 637 F.2d 775, 787 n.57 & text accompanying (D.C. Cir. 1980), cert. denied, 451 U.S. 1128 (1981); F.T.C. v. Compagnie De Saint-Gobain-Pont-A-Mousson, 636 F.2d 1300, 1310-1315 (D.C. Cir. 1980); Ings v. Ferguson, 282 F.2d 149, 151-53 (2d Cir. 1960); United States v. Crews, 605 F. Supp. 730, 736 (S.D. Fla. 1985); In Re Grand Jury 81-2, 550 F. Supp. 24, 27 (W.D. Mich. 1982); United States v. Best, 76 F. Supp. 138, 139 (D. Mass. 1948), aff'd, 184 F.2d 131 (1st Cir. 1950); Restatement (Second) Foreign Relations Law of the United States §44 (1965); Onkelinx, Conflict of International Jurisdiction: Ordering the Production of Documents in Violation of the Law of Situs, 64 NW. U. L. Rev. 487, 499 (1969).

Foreign states would object to the invasion of their sovereignty that would result from service of a CFTC subpoena within their territory. They understandably would take the position that their own laws and procedures, not those of the U.S., should govern within their borders. Service of U.S. subpoenas abroad is likely to lead to conflicts of both substantive and procedural law and to strong adverse reactions on the part of other countries. Thus, enactment of Section 102 would jeopardize the United States' relations with foreign nations.

Furthermore, the CFTC has failed to demonstrate that other and perhaps better methods could not be utilized to obtain information. The Securities and Exchange Commission does not have this power. Rather, with the assistance of the Departments of State and Justice, it has obtained the cooperation of a number of countries, including Switzerland.

While Congress has given the Department of Justice and the Federal Trade Commission the power to issue Civil Investigative Demands on foreign nationals on foreign soil pursuant to 15 U.S.C. § 1212(d)(2) and 15 U.S.C. § 57b-1(c), the power to issue Civil Investigative Demands is more limited in scope than the subpoena powers proposed by the CFTC and is subject to extensive procedural safeguards.

Finally, Section 102 would permit the CFTC to serve and to enforce a subpoena on any individual located anywhere in the world without the need for a showing that such individual had sufficient minimum contacts with the U.S. to justify the U.S. in the exercise of jurisdiction over that individual. As the State Department's Office of Legal Advisor has stated, there is a "(u)niversally recognized prohibitive rule" that a "state may not exercise jurisdiction over foreign events or persons if the state has no genuine link with those events or persons." Robinson, Compelling Discovery and Evidence in International Litigation, 18 Int'l Law 533, 537 (1984). Indeed, the exercise of power over such a person would constitute a violation of due process of law under the Fifth Amendment of the Constitution. See International Shoe v. Washington, 326 U.S. 310 (1945).

Limiting Judicial Review

The Commission requests that a new Section 24 be added to the Act 4/ which would preclude judicial review of Commission actions except through review in the Courts of Appeals on the record created by the Commission which would be conclusive, if supported by "substantial evidence" in the record. The proposed amendment contained in Section 103 would produce three significant and unjustified changes.

First, the amendment would preclude judicial review that is currently available under the Administrative Procedure Act ("APA"), 5 U.S.C. §§701 et. seq., on the basis of a record created before the court. For example, it would preclude a

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4/ Section 103 of the CFTC's bill.

review of Commission action as occurred in Commodity Exchange, Inc. v. CFTC, 543 F.Supp. 1340, aff'd., 703 F.2d 682 (2d. Cir 1983), where the district court found the CFTC's disapproval of COMEX's rules on a record created by the Commission to be insufficient and ordered the Commission to provide the COMEX with an opportunity for an oral hearing.

Secondly, the standard of review proposed is significantly different from that provided for appellate judicial review in Sections 6a and 6b of the Act. These provisions provide that the Commission findings, as to facts, are conclusive if supported by the "weight of the evidence." "Weight of the evidence" and "preponderance of the evidence" standards are generally considered to be equivalent. Both require more than "substantial evidence." 5/ Although the "substantial evidence" standard requires "more than a mere scintilla" 6/, the current standard contained in the other appellate review provisions of the Act (and which will remain in the Act) should be the standard for all appellate review. 7/ Two different standards for review should not be enacted.

5/ Laws v. Celebrezze, 368 F.2d 640 at 642 (4th Cir. 1966); Stewart v. Gardner, 270 F.Supp. 92 (S.D.W.V. 1966), aff'd., 379 F.2d 554 (3rd Cir. 1967).

6/ Richardson v. Perales, 402 U.S. 389 at 401 (1971).

7/ Sections 6a and 6b.

Thirdly, the amendment would for the first time preclude foreign persons from obtaining judicial review. The proposal provides for review only in the Court of Appeals for the circuit in which the person resides or has its principal place of business. A foreign aggrieved person could not qualify for review in either circuit. To bar foreign persons from judicial review of CFTC actions would raise serious due process problems.

Ex Parte Appointment of Receivers

Section 104 of the bill would provide authority for the Commission to request *ex parte* and the federal courts to appoint temporary receivers in civil injunctive actions instituted by the Commission based solely upon the *ex parte* application by the Commission. The additional power the Commission seeks is unnecessary for effective enforcement of the Act and will destroy without notice any business enterprise for which such a receiver is appointed.

Since 1974, the Act (Section 6c) has prohibited federal courts from granting *ex parte* restraining orders in Commission injunctive actions. In 1982, the Commission requested and the Congress amended Section 6c to provide two exceptions to this general prohibition. Thus, *ex parte* restraining orders are authorized (1) to prevent destruction or alteration of or refusals to grant the Commission access to books, records or other documents and (2) to prevent transfer or disposition of funds or other property. 8/ In enacting these exceptions, Congress noted their "limited purpose" 9/ and that they were:

> provided to prevent possible removal or destruction of potential evidence or other impediments to legitimate law enforcement activities and to prohibit movement or disposal of funds, assets and other property which may be subject to lawful claims of customers. 10/

The Commission itself sponsored the amendment and then Chairman Philip McB. Johnson testified:

> Finally, we seek authority to obtain ex parte injunctions to preserve a firm's business records and to prevent the theft of customer funds when, in our judgment, it appears that prior notice to the suspected violator could result in the destruction of those records or the disappearance of those customer funds. 11/

This new power the Commission seeks for the *ex parte* appointment of temporary receivers for "suspected violators", would be the death knell for the business of those "suspected of being a violator," regardless of whether the Commission's suspicions were well-founded. Once a temporary receiver is appointed, the inescapable and justifiable inference for

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8/ Futures Trading Act of 1982, Pub. L. No. 87-444 (1983), codified at 7 U.S.C. §13a-1.

9/ H.R. Report No. 95-565, 97th Cong., 2d. Sess. 31 (1982).

10/ Hearings on H.R. 5447 Before the Subcommittee on Conservation, Credit, and Rural Development of the House Committee on Agriculture, 97th Cong. 2nd Sess. (1982) at 93.

11/ *Id.* at 11.

customers and creditors of the enterprise is that the business is no longer a going concern. Rather, the enterprise has been seized. If the Commission's suspicions about the alleged violator are baseless, and eventually proven so, irreparable damage will have been done with the business seized and the enterprise branded as though it were an adjudicated violator. It would be of little solace that ultimately it was vindicated.

The fact that such an irrevocable and final result may be imposed not only without an opportunity for hearing but even without notice contravenes the federal courts' teachings that appointment of a receiver is a "drastic, harsh, and dangerous" remedy 12/ which should be exercised sparingly 13/ and only where absolutely necessary 14/ and then only in a clear case 15/ where an emergency exists 16/ and where no lesser relief will be effective. 17/ Indeed, the Securities and Exchange Commission does not possess the authority to request the appointment of a

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12/ Connolly v. Gishwaller, 162 F.2d 428 (7th Cir. 1947), cert. den. 332 U.S. 895.

13/ Skirvin v. Mesta, 141 F.2d 668 (5th Cir. 1944).

14/ Strickland v. Peters, 120 F.2d 53 (5th Cir. 1947).

15/ Commodity Futures Trading Commission v. Comvest Trading Corp., 481 F. Supp. 438 (D.Mass. 1979).

16/ Peterson v. Federated Development Co., 387 F. Supp. 355 (S.D.N.Y. 1974).

17/ Ferguson v. Tabah, 288 F.2d 665 (2d Cir. 1961).

receiver ex parte, nor does it appear the lack of such authority has hampered its enforcement of the securities laws. Even the Securities Investor Protection Corporation ("SIPC") does not have such authority. When requesting a "protective decree" it must give notice to the firm and if the firm does not consent to the entry of the order, a hearing must be held within three days. 18/

The Commission asserts that in the period between filing its application for appointment of a receiver with the court and the hearing on that application, which incidentally can usually be held within 24 hours after the application is filed, defendants might flout the ex parte orders already entered by the courts to prevent destruction of books and records or dissipation of customer funds. This justification shrouds the fact that with court-ordered access to the records of the firm (entered ex parte) the Commission is in a position to detect and bring an immediate halt to any violations of a court's order. Such conduct in violation of a federal court order is punishable as contempt, 19/ which the Commission should be able to promptly

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18/ 15 U.S.C. §77eee(b).

19/ See 18 U.S.C. §401 (criminal contempt an indictable offense); Orders entered in actions brought by the Commission are not within the penalty limitations of 18 U.S.C. §402 and thus may be punished as felonies. U.S. v. Duncan, 503 F.2d 1021 (8th Cir. 1974). The Commission need not proceed by indictment of the offending party but may proceed directly under Rule 42 of the Federal Rules of Criminal Procedure. Of course, civil contempt remedies are (Footnote Continued) bring to the attention of the court and to obtain either civil or criminal contempt remedies. The fact that the Commission has not successfully sought such remedies for violation of ex parte asset freeze or ex parte record orders suggests either that the problem is not now significant or that the Commission is not making full use of its existing ample powers.

Nor does the Commission's concern that firms subject to an ex parte freeze order obtained by the Commission may experience administrative difficulties, justify the proposed amendment. The Commission itself can remedy any such perceived problems simply by presenting to the court proposed asset freeze orders which provide, pending further order of the court, for ordinary and necessary business expenditures by the firm. Clearly a federal court which has the power to freeze assets upon ex parte application has the power to craft an order (at the request of the Commission) to accomplish the statutory purposes. The problem here lies not in the absence of a temporary receiver but in the Commission's failure to anticipate routine problems in the administration of freeze orders. With four years of experience in the use of ex parte orders covering approximately twenty different cases, the Commission should be able to avoid administrative difficulties with such orders for any ongoing

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(Footnote Continued)
also available to the Commission in such a case. See CFTC v. Premex, Inc., 655 F.2d 779 (7th Cir. 1981).

enterprise, rather than simply to force the termination of a firm as a going concern by appointment of an *ex parte* receiver.

In short, providing the Commission with the authority to obtain the appointment of an *ex parte* receiver will provide it with the power to destroy the business of any "suspected violator" without either notice or hearing. The requested new authority simply is not necessary. No matter how laudable the Commission's objectives, there are less drastic and more just means to accomplish these ends.

John H. Stassen
Chairman
COMMITTEE ON FUTURES
REGULATION

Mahlon M. Frankhauser
Chairman
Special Task Group on 1986
CFTC Reauthorization, Committee
on Futures Regulation

Mark N. Rae

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Vice-Chairman
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MEMBERS OF THE N.Y. BAR
* ALSO MEMBER OF THE D.C. BAR

April 4, 1986

Mr. Robert A. Cashdollar
Subcommittee on Conservation,
  Credit & Rural Development
Committee on Agriculture
U.S. House of Representatives
1301 Longworth Bldg.
Washington, D.C. 20515

Dear Bob:

At the recent House hearings, Ed Jones asked John Damgard to describe some of the off-exchange transactions that John had referred to in his testimony, and I gather John is complying with that request.

I think it is clear that some sort of relief is needed for off-exchange transactions in the financial arena because the Commodity Exchange Act as it is presently drafted is casting an unintended and unnecessary cloud of legal uncertainty over financial transactions to which the Act should really not apply at all.

I am enclosing a copy of an article I expect to have published within the next few weeks, which you may find of interest.

With all best wishes,

Sincerely yours,

Ed

Edmund R. Schroeder

ERS/mp
Enclosure

cc: Mr. Damgard (w/enc.)

April 7, 1986

INADVERTENT FUTURES CONTRACTS

By Edmund R. Schroeder

Section 4(a) of the Commodity Exchange Act (the "Act") makes it unlawful to enter into any contract for the future delivery of a commodity ("futures contract") other than on or subject to the rules of a commodity exchange that has been designated as a "contract market" by the CFTC. Section 2(a)(1) of the Act defines the word "commodity" to mean, in addition to enumerated agricultural commodities, anything that is the subject of a futures contract.

Any contract that calls for the delivery of something in the future, potentially constitutes a "futures contract". If it does, then the item underlying the contract becomes a commodity, and the contract may not be entered into unless it is traded on an exchange. If contracts of that.type are not traded on an exchange, then the particular contract may not be entered into at all, regardless of who the parties are and regardless of its social utility.

This situation, which was never intended by Congress but was the result of historical accident, needlessly casts a cloud of legal uncertainty over billions of dollars of transactions by banks and other financial institutions.

Some History

It is not clear why there should be a ban on off-exchange futures contracts, and Congress has never stated a policy reason for doing so. The ban now contained in Section 4(a) dates back to the original precursor of the Commodity Exchange Act, adopted in 1921. The original legislation was enacted to deal with the grain markets. At that time, farmers were complaining that speculation by futures traders was manipulating the price of grain to artificially low levels. Responding to this need, Congress was prepared to ban grain futures trading altogether. However, it carved out an exception for grain futures traded on an exchange (principally thinking of the Chicago Board of Trade), in a trade-off whereby any such exchange would have to be subject to regulation by the Department of Agriculture and would have to agree to prevent the manipulation of grain prices. However, it is important to note that there was no general ban adopted on off-exchange futures. Indeed, no commodity other than the grains was subject to the original legislation. Over the years until 1974, other items were added to the list of regulated commodities. Those items generally had characteristics analogous to grain, i.e., they were domestic agricultural products grown by farmers, cattle growers or other producers, marketed through dealers such as elevator operators and ultimately either exported or sold to domestic processors.

In 1974, the thrust of the Act was shifted from an enumerated list of commodities to a generic concept that anything that is the subject of a futures contract ipso facto constitutes a commodity, regardless of its economic attributes, and thus is subject to the same regulatory scheme as the agricultural commodities. That state of affairs is complicated by the fact that there does not exist in the Act, the regulations of the CFTC or anywhere else a definition of what a futures contract is.

Although there is no definition of what a futures contract is, there is one specification in the Act of what it is not. Any sale of a "cash commodity" for deferred shipment or delivery (generally referred to as a "forward contract") is not a futures contract and therefore is not subject to, among other things, the ban on off-exchange transactions. However, having excluded forward contracts from futures contracts, the Act does not define what a forward contract is either.

The CFTC, the courts and the commentators have struggled at great length with this problem. Generally, they have concluded that there are a number of components in the distinction between the two types of contract. There is some disagreement as to just how much weight should be given to each, but there seems to be a common thread that the most significant consideration is the probability of physical delivery of the underlying commodity. This reflects the fact that when Congress originally banned grain futures, it recognized that every contract between a farmer and a grain elevator operator was literally a contract for the future delivery of a commodity. Since those contracts were of course not transacted on exchanges, an exclusion had to be adopted to permit farmers to sell their crops on a deferred delivery basis. Therefore, at the time the forward contract exclusion was adopted, the prospect of physical delivery was undoubtedly very significant. Today many lawyers feel that delivery itself is not so important, and that a transaction will qualify as a forward contract merely if it is between commercial parties for commercial purposes, even if it is settled in cash. However, there is not unanimous agreement on this point and the correct legal interpretation cannot be regarded as well settled.

The full implications of this radical change were not thought out in 1974 and have never really been fully addressed by Congress since. There was no conscious policy decision by Congress to ban off-exchange financial transactions by commercial parties. The impact on those transactions merely was the inadvertent result of a change in the definition of what is a commodity, and the expansion of the scope of the Act into areas with which the Agriculture Committees in the House and the Senate were not familiar.

A brief flash of awareness about this problem occurred just prior to adoption of the 1974 legislation, when the Treasury Department sent an eleventh hour appeal to the Congress to except certain enumerated financial products from the scope of the Act entirely. That exception, which is embodied in what is now known as the "Treasury Amendment," is limited to foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, and mortgages or mortgage purchase commitments.

Effect on Financial Transactions

Many financial products which should also be excepted from the coverage of the Act are not included in the Treasury list, both because the list was compiled without adequate participation by financial institutions, and because innovation over the last decade has brought into existence numerous financial products that simply did not exist in 1974.

One example of the kind of transaction that presents the problem is the so-called forward rate agreement. Under this type of transaction, two financial or commercial entities (typically, but not necessarily, banks) enter into a contract whereby one agrees to "purchase" and the other agrees to "sell" a loan in a specified amount (usually in multiples of $10 million) at some specified market interest rate, such as the London Interbank Offered Rate ("Libor"), on some specified day in the future. If Libor goes up or down between the contract date and the delivery date, one party will make a payment to the other of an amount computed according to an elaborate formula that will compensate the other for the loss in value of the commitment. These transactions often use the language of purchasing and selling, which makes them look like futures contracts. But even if the verbal formulation were to be changed, the underlying economics arguably would make them futures contracts in substance even if not in form.

If a forward rate agreement is a futures contract, the underlying Libor commitment becomes a commodity, and the contract is prohibited (unless an exception applies). Since final settlement is made in cash without physical delivery, it is at least open to question whether the forward contracts exception applies. Since a Libor commitment is not one of the excepted items listed in the Treasury Amendment, that Amendment does not apply. Therefore, the legality of executing off-exchange forward rate agreements may be open to question.

It should be noted that the effect of Section 4(a) in a case such as this is not to force the transactions to be traded on exchanges. There are no forward rate agreements traded on exchanges. They are not suitable for exchange trading because of their size, their relative infrequency (which would translate into illiquidity on an exchange floor) and the fact that the delivery dates are selected to suit the needs of the particular parties.

The European financial community makes extensive use of forward rate agreements and other financial products whose legality is unclear under U.S. law. There is no sound reason why the U.S. financial community should be at a disadvantage in these areas.

Possible Solutions

Congress has never clearly articulated policy reasons for having a ban on off-exchange futures. The arguments that are sometimes made are that exchange oversight provides a measure of public protection by combating fraud and unethical practices. In addition, exchanges provide competitive price-making in a centralized market, with price discovery.

However, the protections that are desirable in a market with public participation are unnecessary and can be unduly burdensome in a market composed of sophisticated, commercial participants that have no need of such protections. Recognition of this circumstance is contained in the Act itself, which, while it bans off-exchange commodity options generally, explicitly permits off-exchange options where the purchaser is a commercial user of the underlying commodity.

This is not a call for the repeal of Section 4(a). It is merely to point out that unintentionally, and without a conscious Congressional policy decision, Section 4(a) is operating in a way that can impede innovation in financial risk management. Exceptions should be explicitly permitted for off-exchange transactions where the public interest would not be adversely affected.

One possibility would be to amend the Act to provide that a transaction would not be considered a futures contract if (a) the underlying item is a financial interest, and (b) the ultimate participants are banks, insurance companies, securities or commodities dealers or other financial institutions or commercial entities. Then since such an amendment would probably not reach all of the transactions that should be excluded from Section 4(a), the Act should be further amended to grant the CFTC statutory authority to exempt particular persons or transactions, or classes of persons or transactions, from the scope of Section 4(a) upon a finding that it would not be contrary to the public interest to do so. Precedent for such authority exists in the securities area, where the SEC has the power to grant exemptions from certain provisions of the securities laws upon such a finding.

Such an approach would help to eliminate an unintended and onerous burden on the risk-management activities of financial and commercial entities.

DEAN WITTER REYNOLDS INC.
#5 World Trade Center, New York, NY 10048   Telephone (212) 524-2222

March 31, 1986

Honorable Ed Jones
Chairman, Subcommittee on Conservation,
Credit, and Rural Development
Committee on Agriculture
United States House of Representatives
1336 Longworth House Office Building
Washington, D.C. 20515

RE: CFTC Reauthorization Legislation

Dear Mr. Chairman:

Dean Witter Reynolds Inc. ("Dean Witter") respectfully submits this statement for the record in connection with your Subcommittee's consideration of legislation to reauthorize the Commodity Futures Trading Commission ("CFTC").

Dean Witter, a wholly owned subsidiary of Sears, Roebuck and Co., is registered with the CFTC as a futures commission merchant. It is also registered with the Securities and Exchange Commission as a broker-dealer in securities. This submission will cover two separate but interrelated issues; the restriction on the number of speculative contracts a trader may hold or control in a particular future or option and the need to revise the CFTC's aggregation policies.

I. Speculative Position Limits.

Under CFTC Rule 1.61, the commodity exchanges are required to impose speculative position limits on all their futures and option contracts, except for certain agricultural futures contracts which have CFTC-set limits. Position limits set a cap on the number of each futures or option contract which may be held by any person for non-hedging purposes. We feel that the CFTC's policies on speculative position limits have not kept pace with the evolution of the commodity futures and options markets and as a result create unjustified impediments to legitimate activities for participants in the futures markets.

Speculative limits were initially designed (1) to prevent market manipulation and congestion, especially in delivery months, and (2) to prevent the unwarranted price impact that very large positions were thought to have even in active markets. Even assuming the past validity of these concerns for some futures markets, speculative position limits are too low for financial futures markets where contracts are settled in cash or are subject to arbitrage with liquid cash, futures and/or option markets in other countries.

For example, the position limit in the Chicago Mercantile Exchange's S&P 500 stock index futures contract, a very liquid cash settled contract, is 5,000 contracts net long or net short in all contract months combined. At the current level of the S&P 500 index, the cash value of 5,000 futures contracts on the index is approximately $600 million. Although this is a substantial amount, it does not begin to accommodate institutional users who have billions of dollars under management. Moreover, the position limit for the S&P 500 stock index is actually higher than the limits for many other contracts. The limit for cotton futures, for instance, is only 30,000 bales or approximately 300 cotton futures contracts which has remained unchanged since 1940. These low limits hamper the ability of money managers who direct the trading on behalf of commodity pools or managed accounts from implementing their trading strategies.

Under Rule 1.61, the exchanges may raise position limits only with the CFTC's concurrence. We believe that the Subcommittee should direct the CFTC to reevaluate the existing levels of speculative position limits on all contracts, permit the exchanges to increase exchange-set limits and increase CFTC-set limits on the agricultural futures contracts.

II. Aggregation Policies.

The issue of speculative position limits is directly related to the CFTC's aggregation policy, under which positions in all accounts *owned or controlled* by the same person must be aggregated for speculative position limit purposes. In the commodity pools it sponsors Dean Witter utilizes multiple, independent trading advisors to manage and separately trade a specified amount of the total monies deposited in each pool.

Under the CFTC's current policy, ownership by itself, even in the absence of actual control, can serve as the basis for aggregating positions. Thus, even though a pooled investment vehicle divides the responsibility for managing assets among various money managers, each of whom operates independently of a fund's other advisors, the positions assumed by each of the advisors for a particular fund would be added together for speculative limit purposes because those positions are owned by the same entity.

We believe that the CFTC's aggregation policies should make actual control over a particular account rather than apparent control, through ownership or other means, the cornerstone of its aggregation policy. In this regard, we note that the option exchanges in the securities industry aggregate positions in securities options on the basis of control, and not ownership.

The opportunity to furnish comments to Congress through these reauthorization hearings permits Congress to conduct a periodic review of the CFTC's regulations and the Commodity Exchange Act. In this context, we feel the Subcommittee should address the issues of speculative position limits and aggregation policies to bring these rules and regulations in line with the rapidly changing environment of the futures markets.

Respectfully submitted,

Gordon E. Swartz

Gordon E. Swartz
First Vice President,
Commodities Counsel

GES/ss

REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

WEDNESDAY, MARCH 19, 1986

House of Representatives,
Subcommittee on Conservation,
Credit, and Rural Development,
Committee on Agriculture,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 1300, Longworth House Office Building, Hon. Ed Jones of Tennessee (chairman of the subcommittee) presiding.

Present: Representatives Weaver, Glickman, Daschle, Stenholm, Tallon, Thomas, Coleman, Morrison, Gunderson, and Evans of Iowa.

Also present: Representative E (Kika) de la Garza, chairman of the committee, and Representative Emerson, member of the committee.

Staff present: Phillip L. Fraas, counsel; William E. O'Conner, Jr., assistant minority staff director; John E. Hogan, minority counsel; Glenda L. Temple, clerk; Robert A. Cashdollar, James W. Johnson, Jr., Fred Clark, Bernard Brenner, and Susan Adkins.

OPENING STATEMENT OF HON. ED JONES, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TENNESSEE

Mr. Jones of Tennessee. Good morning.

The Subcommittee on Conservation, Credit, and Rural Development will come to order.

This morning, we are continuing with testimony on the reauthorization of the Commodity Futures Trading Commission. At this time, I am ready to call up panel No. 1: Mr. John Gilmore, chairman of the Chicago Board of Trade; Mr. Warren Lebeck, National Grain Trade Council of Washington; Mr. Philip Feigan, chairman of the Commodities Committee, North American Securities Administrators Association of Denver; and Mr. John D. Brookmeyer, Jr., vice president of the Prudential Insurance Co. of America.

We will follow the panel in the order that their names appear on the witness list, and Mr. John Gilmore, chairman of the Chicago Board of Trade, will be heard first.

Here we are with a vote already. Let's recess and go vote. Just be at ease, ladies and gentlemen, until we return which should be about 15 minutes.

[Recess taken.]

Mr. Jones of Tennessee. Mr. John Gilmore, chairman of the Chicago Board of Trade is here. Mr. Gilmore, thank you for coming. I note that you are accompanied by Thomas Donovan. Mr. Donovan, we appreciate your presence also. You may proceed.

STATEMENT OF JOHN F. GILMORE, CHAIRMAN, CHICAGO BOARD OF TRADE, ACCOMPANIED BY THOMAS R. DONOVAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER

Mr. Gilmore. Thank you, Mr. Chairman.

I am John Gilmore, chairman of the Chicago Board of Trade. I was elected chairman of the Chicago Board of Trade early in January 1986. My background, however, in the commodity business goes back 20 years with principally two firms, E.F. Hutton & Co. and now Goldman Sachs of New York.

My commodity background, however, goes back familywise to just after the Civil War when my grandfather, Allison Gilmore, was one of the founders of the Chicago Stockyards. My father also operated that same business along with myself for over 50 years.

I am here today to represent the world's largest futures exchange and discuss our concerns about competition, regulation, and how the Chicago Board of Trade perceives the next 5 years in regard to the commodity business.

My central theme today will be that we have four regulatory concerns. These four regulatory concerns are: audit trails, capital rules, speculative limits, and Ag Option Pilot Program.

Prior to getting into each one of those individual concerns, I would like to express my belief that competition for what Chicago has done in the last 10 years is now abounding in every foreign financial center. The envy with which our foreign competitors look upon the Chicago phenomenon is without precedent. Currently, in Paris, London, Tokyo, and Sidney, there are active exchanges seeking to adopt the Chicago style of trading and therefore take our business overseas.

We in Chicago, whether it is the Chicago Board of Trade or the Chicago Mercantile Exchange, are very proud of what has developed over the last 20 years. We intend to try everything to keep that business in the United States and do it in a manner that is a credit not only to ourselves but to the Commodity Futures Trading Commission.

In reviewing this and looking at our competitors, we came to one conclusion: It would be extremely easy to export our business by overregulation. The first principal area of this is what we call audit trails or what sometimes has been erroneously called in the press "1-minute time stamp."

I would like to say from the outset that I believe that the solution of the Chicago Board of Trade and the Chicago Mercantile Exchange does in fact address the Commission's 1.35g interpretation contained in their March 4 letter to Senator Lugar. I do believe, however, that there are serious things that this program developed that deserve review.

The 1-minute time-stamping final rule, promulgated on January 14, 1986, was an unattainable standard in my opinion. The adoption of unattainable standards can only cause consternation among the industry and consternation among the users of our market.

The Chicago exchanges took this final rule, however, and decided that the course of action should be one of unprecedented cooperation between two highly competitive Chicago institutions. Early on, in February, this cooperation was extended to the Commodity Futures Trading Commission in the person of Chairwoman Susan Phillips and her staff.

We met with them and developed a concept that we call CRT. This concept will represent an expenditure by the exchanges in the months ahead that will virtually eat up our research and development budgets for 1986 and 1987.

The thing I would like the panel to understand today is that we believe we have had a solution. I, as a member of three separate exchanges, believe that this solution is far superior to any other solution that exists on any exchange that I am familiar with. True, there can be solutions to this problem when you have computer talking to computer, but when you introduce the human element and the human decision process which is key to our markets into the marketplace, this system adapts the human element in a better fashion than anything that I know of.

The second area of our concern is what we call capital rules. In August 1985, the Commission promulgated a set of capital rules that would have had serious economic effects. A significant percentage of our member firms would have been undercapitalized and, therefore, out of business.

That brought about an unprecedented avalanche of letters in the industry. One of the letters, and I quote, said that "the capital rules proposed are like using a nuclear warhead where a fly swatter would do." This was from a prominent, well known commodity multinational corporation.

I think there should have been additional testing of capital rule concepts, and I look forward to the belief that when the industry puts forth a capital rule compromise on April 4, 1986, the CFTC and the industry will be able to work a reasonable compromise that is better than the capital rule that exists today.

The 4- to 6-percent standard of segregated funds which exists today I do not believe adequate for today's marketplace. It was adopted at a time when less than 50 percent of the contracts we now trade were available for trading. It was a simplistic approach to a complex problem. It may have got us to 1985, but to get us beyond, I think we need to look at the risks inherent in the business, not at the amount of money on deposit, and those are two entirely separate discussions.

Also, as a matter of fact, I think that the record of the commodity industry as a whole ought to be looked at. In the last 46 years, less than $10 million in customer funds have been lost in the commodity business. When we compare that to the securities business or Securities Investors Protection Corporation pay outs of $153 million in 14 years, or even more, the two failures in the unregulated government securities market, VSM and Bevill-Bressler last year of over $500 million, I think we believe that the record of the commodities industry for fiduciary responsibility is one that we should be proud of and that our regulators should be proud of.

The spec limits question or the amount of contracts that an individual participant in the market can own or control is a vexing question at best. The last time it was actively addressed was in 1971. Crops in the United States have approximately doubled since 1971, but there has been an important, inherent change in our marketplaces.

The Chicago Board of Trade is no longer a regional grain exchange. It is, for all practical purposes, an international price discovery mechanism that allows foreign customers of ours to set prices in U.S. commodities. This means that the Chicago Board of Trade feels strongly that the speculative limit issue should be readdressed and that they should reflect today's market, not the 1971 market.

Our fourth regulatory concern is one of the options pilot program. The development of agricultural options, I think, has been one of the successes of the current Commodity Futures Trading Commission, especially under the leadership of Chairman Phillips and Commissioner Hineman.

This is the private sector's supporting program for farm support. If agricultural options are allowed to expand and become actively traded instruments, either on the Chicago Board of Trade or another exchange, it does represent the possibility of being the free market solution to the ever vexing problem facing this committee and Congress as a whole as what to do about farm price supports.

We believe that the agricultural pilot program status should be lifted and each exchange should be allowed to list ag options with the approval of the Commodity Futures Trading Commission.

In conclusion, I would like to say that the cooperation of the Commodity Futures Trading Commission on whether it was audit trails or capital rules has been unprecedented during the last 6 months. I have been director of the Chicago Board of Trade for the previous 9 years, and I think that the atmosphere, especially in the last 90 days, on the audit trail question has been much more desireable than it had been in the past.

We do have some risks, however. We do have some concerns. I have enumerated those, but let me approach the subject from a different point of view.

It will be very easy to export our business. Our competitors overseas are ready, willing, and able to adapt our contracts with nothing more than a Xerox machine at their disposal. They can copy, they can promulgate, and start trading new contracts in as short a period as 22 days.

Every night in Chicago banks, there is between $3 and $4 billion in deposits for margins on Chicago exchanges. The interesting part of that is anywhere from 33 to 40 percent of that represents deposits from overseas. That is a significant business development for Chicago banks and banking in general.

My key concern, however, is that innovation or what I call the Chicago innovations from 1968 to 1985 will be stifled by over-regulation. I do have some experience in that seeing that I participated in a good number of these in my 20-year career. Let's look at the record of what the Chicago exchanges developed in the last 20 years.

They founded a whole industry in listed options. They started currency trading, currency futures, and currency options. They started trading in interest rates and stock indexes. These are now major components of our business, and they are direct products of the Chicago innovation. I did participate, however, in one other area in Chicago that was not quite so bright.

In conclusion, I would like to give you a very personal observation on over-regulation. During the last 10 years of my family firm being in business at the Chicago Stockyards, we had more regulators than regulatees. We don't have that problem any more. There isn't any Chicago Stockyards any more; there are just parking lots and warehouses.

I intend to use my chairmanship of the Chicago Board of Trade to promote innovation and cooperation with the CFTC but also to be on the watch for over-regulation.

Thank you.

[The prepared statement of Mr. Gilmore appears at the conclusion of the hearing.]

Mr. JONES of Tennessee. Thank you, Mr. Gilmore.

Mr. Donovan, do you have any statement?

Mr. DONOVAN. No; Mr. Gilmore's statement is ours.

Mr. JONES of Tennessee. The next witness is Mr. Warren Lebeck, National Grain Trade Council of Washington.

Mr. Lebeck, you may proceed.

STATEMENT OF WARREN W. LEBECK, MEMBER, BOARD OF DIRECTORS AND EXECUTIVE COMMITTEE, NATIONAL GRAIN TRADE COUNCIL

Mr. LEBECK. Thank you, sir.

Mr. Chairman and members of the committee, my name is Warren Lebeck. I appear before you today representing the National Grain Trade Council. I am a member of the council's board of directors and executive committee.

The council is a national trade association whose policymaking members include grain exchanges, boards of trade, and national grain marketing associations. Those who represent the organizations on the council are all users of the agricultural futures markets. As users of the markets, they are vitally interested in how the markets function and how they are regulated. Consequently, the council appreciates this opportunity to appear before the subcommittee to present its views on the CFTC.

To a great extent, the reauthorization process has boiled down to two issues, capital requirements and an audit trail. Hopefully, the views of market users will be helpful to you.

The statement we submitted for the record addresses several of the other issues.

For council members as users of futures markets, the economic viability and utility of the markets is of the utmost importance. There is a natural concern about the capitalization of exchange member firms. Yet, experience in the agricultural markets has been exemplary. The manner in which the agricultural futures markets handled the volatile 1973 markets when grain prices reached all-time highs and the manner in which these same markets handled a financial problem occurring at practically the same time as the volume investors situation, leads the council and its members to have great confidence in the experience and professionalism of these markets and their ability to handle financial difficulties.

The CFTC proposals would appear to further concentrate the business in fewer and fewer hands, which could only lead to greater risk should there be a problem.

What is significant is that had present rules and procedures been followed in the Volume Investors situation, the problem might not have occurred or at least would have been greatly minimized.

Quite frankly, it appears that the CFTC has reacted with an axe when a scalpel in the hands of those skilled in these matters would have sufficed. What is needed is a properly constructed capital rule carefully drawn with inputs from those who have successfully weathered financial storms.

Members of the council are also, of course, concerned that their orders be handled correctly on the floors of the exchanges. But, there are more concerned that their orders be handled expeditiously. In active markets, a delay of even a few seconds can mean missing the market or getting a much less satisfactory fill.

In an interview in Intermarket, the immediate past chairman of the Chicago Board of Trade put it well. He said,

> I think there is a basic difference in philosophy and a difference in goals. For example, we want to give the most efficient price or the best price for the customer. And many times, somebody with an accountant's or lawyer's mentality is looking for the easiest way to get the order back to the customer.

The Commission and its staff seem to have ignored the economic impact that their proposal will have and have most certainly ignored studies submitted by the Chicago Board of Trade while having made no comprehensive studies themselves. The refusal of the Commission to take into account the consequences of its proposal and its effect on the public interest is disturbing to those who use the market and will be affected by such shortsightedness.

One also wonders if the CFTC has considered the fact that its proposal seems to give any broker an automatic excuse for unsatisfactory fills—"Sorry, I was time recording executed trades wh the market moved."

This leaves council members and other users of the market faced with the dilemma—which is the greater threat—the possibility that an order will be mishandled or the reality that 1 minute time recording will delay executions? After reviewing the audit trail proposals submitted by the Chicago Board of Trade and the Chicago Mercantile Exchange, the council and its members are convinced that these give adequate protection against possible abuse without having to disrupt market activity.

It interested me that the Chairman of the Commission at the Senate hearings acknowledged that most transactions are handled properly. Why, then, risk upsetting functioning markets?

The Chairman also said one reason for their audit trail proposal was allegations of price manipulation in the 1983 grain markets. I fail to see the connection between manipulation and a broker racing an order. The allegations of manipulation were leveled against the suspicion that large firms had made large speculative trades to influence price. Even an absolutely perfect audit trail would have told you nothing of the intentions of any such orders.

I would also like to describe for you a scenario. A broker has a dozen or more stop orders in his deck all triggered by the same price. That price is reached. There are 12 orders or more to execute as rapidly as possible and that could mean many more than 12 separate transactions. Does the broker time record each separate transaction? Does he record what is done within each minutes? Or does the broker execute all the stops and then record? What about a market order that comes in while he is executing stops?

One final comment. When reviewing the performance of the CFTC, I am reminded of a definition of an economist that I have heard: an economist is one who observes something that works and then spends time wondering if it will work in theory. Things like capital rules and audit trails.

I understand that yesterday, one member of the subcommittee asked what was the most important single item in CFTC reauthorization. Several answers were received. I thought they were all quite parochial. To me, the answer is simple. What is needed is more appreciation by the CFTC of what the markets do and more appreciation for the experience of those who have kept their markets function successfully lo these many years. A little more responsiveness to the industry users and exchanges is all that is needed, and it seems only reauthorization hearings accomplish this.

Again, our thanks for the privilege of presenting our views.

[The prepared statement of Mr. Lebeck appears at the conclusion of the hearing.]

Mr. JONES of Tennessee. Thank you very much, Mr. Lebeck, for your statement.

The next witness is Mr. Philip Feigan, chairman of the Commodities Committee, North American Securities Administrators Association of Denver.

STATEMENT OF PHILIP A. FEIGAN, ASSISTANT SECURITIES COMMISSIONER, COLORADO DIVISION OF SECURITIES, AND CHAIRMAN, COMMODITIES COMMITTEE, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

Mr. FEIGAN. Thank you, Mr. Chairman, and members of the subcommittee.

I am the assistant securities commissioner for the Colorado division of securities and, as you said, serve as the chairman of the commodities committee of the North American Securities Administrators Association, or NASAA.

I have prepared and submitted a written statement and ask now that it be incorporated in the written record.

Mr. JONES of Tennessee. Without objection, it will be made a part of the record.

Mr. FEIGAN. Thank you, sir.

NASAA is a not for profit volunteer organization composed of the securities regulators of the 50 States, the District of Columbia, the Canadian Provinces, Puerto Rico, and Mexico. Although I believe the views I will express here today are generally reflective of the membership, they should not be construed as binding on any particular member jurisdiction.

I am here today to discuss three general topics important to the States regarding the commodities industry: One, the relationship between the States and the Commission; two, the continuing problem of off-exchange commodities-theme fraud; and, three, leverage.

In past hearings such as this, to the States, CFTC was a four-letter word. In the last 4 years, the Commission has worked very hard to improve its relationship with the States. I am happy to report that they have succeeded.

With the advent of section 6d and 12(e) of the Commodity Exchange Act, the States have begun to assume their proper role in the fight against commodities boiler room fraud. The CFTC and various States have brought numerous joint actions under section 6d. Some jurisdictions have successfully pursued violators under other State laws, taking advantage of section 12(e).

CFTC, NFA, and NASAA cooperation is further evidenced by joint enforcement training seminars, strong and active State advisory committee to the CFTC, and the drafting and publication of the model State commodity code. This code, designed as a modern bucket shop law, is meant to take advantage of section 12(e), giving States adopting it clear jurisdiction to pursue off-exchange commodities theme fraud.

I am pleased to announce that the States of Missouri, New Mexico, and Washington have adopted the code. Legislation is now pending in Minnesota, Maine, and Arizona, and several other States are planning legislation in upcoming sessions.

In summary, NASAA and CFTC relations are no longer problematic. A strong partnership has been forged in the fight against boiler room con artists, and it is quite a fight. It is reported there are at least 100 or more identified boiler rooms in southern California alone, presenting bizarre instruments that under analysis reduce to nothing more than fraudulent, illegal off-exchange futures contracts. These are well funded operations, likely pulling in many millions a year from unsuspecting investors across the country.

The Commission and the States have the expertise, will, and dedication to eradicate this problem. We simply lack the resources. This is a year in which many Federal and State agencies and programs will be vying for scarce budget dollars. Even so, one must certainly understand that millions lost to thieves using phones and the mails to commit their crimes are millions lost to legitimate enterprises, investment, and perhaps speculation. There must come a point in time when the reality of public injury cries out for expanded enforcement resources. Only with the rededication of the Congress to address this problem through directives and funding to the Justice Department, U.S. attorneys, the FBI, the Commission, and law enforcement agencies in general will meaningful inroads be made.

This brings me to the third and perhaps most direct issue of the day, and that is leverage. NASAA joins with the Commission and the exchanges in wholeheartedly supporting the proposed elimination of leverage contracts from the commodities scene. Both the

CFTC Senate reauthorization bill proposal and Congressman Glickman's H.R. 3434 would accomplish this end.

At least eight distinct reasons can be cited for getting rid of leverage contracts. One, they have no economic value or purpose. They are not used for hedging. They are purely speculative and poor bets at that. CFTC economists and others agree that they would not meet the tests necessary to qualify for trading on an exchange. They serve no valid economic purpose.

Two, leverage trading involves no exchange or clearinghouse. The liquidity, stability, credibility, and policing provided by exchanges and clearinghouses in the traditional futures markets are completely absent in the leverage business. The trade is between the leverage customer and the company alone. Prices are set by the leverage company. Futures markets provide a means of price discovery through a system of open outcry and a public forum. Leverage company prices are set by the leverage companies.

Four, leverage company is the principal in the transaction. In the traditional futures markets, the exchanges provide a forum where buyers and sellers trade and the exchanges are paid for their services. The exchanges are essentially neutral. In the leverage business, the other side of the customer's transaction is always taken by the house, the leverage company. There is no such neutrality.

Nontransferability. The customer of a futures commission merchant can transfer his holdings to another FCM, but a leverage customer must always deal with his leverage company. He cannot transfer his positions to another firm.

Danger of misperception. The commodities markets are not for everyone, and it is common knowledge among most consumers that commodities trading is highly volatile with equally high risks of loss. Leverage contracts have often been sold by the telephone to unwary customers across the country on the premise that they are a means to buy gold or silver over time as a hedge against inflation. The public may not understand that they are in fact off-exchange futures contracts with all the risks of loss associated with futures trading and not even all the protections of exchange trading.

Seven, a foot in the door. For many years, four leverage companies had a monopoly on the business. The number is now down to two. Unless the Congress bans these leverage company futures contracts, it is hard to believe the moratorium on new participants entering the market will continue. We are extremely fearful that the existing scheme of regulation with resources at current levels will be wholly incapable of effectively regulating additional leverage companies. The Commission had grave difficulty dealing with four.

In addition, if off-exchange futures trading is allowed to persist, how long will it be before pressure to expand product lines leads to leverage contracts in wheat, corn, plywood, pork bellies, and perhaps even a stock index? The concept is chilling.

Finally, eight, there is no State presence in the off-exchange field. The only reason that the off-exchange securities offerings marketplace works is the presence of State blue sky agencies serving as the cops on the beat. Through the system of concurrent securities jurisdiction, the SEC and the States share regulatory responsibility over the off-exchange sale of securities. There is no such backup for the CFTC should off-exchange futures trading be allowed to continue and, I submit, to inevitably grow.

In summary, leverage contracts have no economic viability. They would never be allowed if originally proposed today. A mistake made 12 years ago must be corrected. It is true that the elimination of leverage contracts would cause Monex and IPMC to significantly alter their mode of business, a fact I am sure their representatives will discuss when they testify in a few moments.

I believe it is a choice between these two special interests and the general public interest, a Hobson's choice which must be made in favor of the public. While it can be argued that the exchanges oppose leverage for competitive reasons and the modus of the CFTC might be self-serving, NASAA's position derives solely from our interest in consumer protection. Monex and IPMC, once again ask you in effect to move the river closer to suit the town. That will simply cost the public too much. We urge you to once and for all do away with off-exchange futures trading to abolish leverage.

Thank you.

[The prepared statement of Mr. Feigan appears at the conclusion of the hearing.]

Mr. JONES of Tennessee. Thank you very much, Mr. Feigan, for a statement that we will certainly take a good look at.

Our next and final witness on this panel is Mr. John Brookmeyer, Jr., vice president of the Prudential Insurance Co. of America, accompanied by Marilyn G. Field.

Mr. Brookmeyer, you may proceed.

STATEMENT OF JOHN D. BROOKMEYER, JR., VICE PRESIDENT, THE PRUDENTIAL INSURANCE CO. OF AMERICA, ON BEHALF OF THE PRUDENTIAL INSURANCE CO. OF AMERICA, METROPOLITAN LIFE INSURANCE CO., AND THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES, ACCOMPANIED BY MARILYN G. FIELD, ASSISTANT GENERAL COUNSEL, THE PRUDENTIAL INSURANCE CO. OF AMERICA

Mr. BROOKMEYER. Mr. Chairman and members of the subcommittee, I am John Brookmeyer, vice president of the Prudential Insurance Co. of America. With me is Marilyn Field, assistant general counsel of Prudential.

I am in charge of the publicly traded fixed income investments for the Prudential. I am appearing this morning on behalf of the Prudential, Metropolitan Life Insurance Co., and the Equitable Life Assurance Society of the United States.

As three of the Nation's largest life insurance companies, we have been in the institutional investment management business for many years, and we currently provide investment management to client portfolios whose total value is in excess of $180 billion.

As investment advisors, we are already regulated in several capacities, including as registered investment advisors under the Investment Advisers Act of 1940 and as ERISA fiduciaries in our management of pension plan assets. Within the last few years, institutional investment managers such as insurance companies have begun to utilize financial futures contracts and related options as aids in the management of their clients' securities portfolios. This has led to the possibility of unnecessary and ill-suited regulation under the Commodity Exchange Act which is a topic Mr. Severs mentioned yesterday that I would like to address today.

Specifically, the problem that has arisen for insurance companies and other institutional investment advisers is that, under present law, we will be deemed to be commodity trading advisers, or CTA's, simply because we use financial futures in connection with our management of large securities portfolios. Registration as a CTA would subject us to regulations which were designed for traditional CTA's and are burdensome and ill suited to our business.

This issue has not yet been adequately addressed by the CFTC but is becoming critical for us as the demand from our clients grows.

Financial futures and related options are very useful tools that help professional money managers deal with the risks of today's unpredictable and volatile capital markets in managing large securities portfolios. The financial futures markets are large and liquid and have relatively low transaction costs. Because of these and other characteristics, financial futures and options on such futures can effectively be used to hedge or otherwise manage the risks connected with fluctuating interest rates or stock market movements on portfolios of debt and equity securities.

Indeed, the usefulness of futures and related options is now widely acknowledged by institutional investors such as pension funds, and it is not uncommon for such clients to request their investment managers to use these instruments in managing their securities portfolios.

Our written statement discusses in considerable detail exactly why we believe that regulation of insurance companies and other institutional investment advisers as CTA's is both unnecessary and inappropriate. First and foremost, regulation as an investment adviser under the Investment Advisors Act of 1940 already provides Federal regulation in each of the areas covered by CTA regulation. Thus, to the extent that CTA regulation is appropriate, it is duplicative of regulation already imposed by the SEC.

The problem is more than one of duplicative regulation, however. CFTC regulation of CTA's also imposes further duties that, because they were developed for persons engaged in providing advice regarding the speculative trading of physical commodities, are inappropriate as applied to institutional investment advisors. These requirements include harsh and misleading disclosure statements, inappropriate performance records, examinations, and finger printing requirements for directors and officers.

Moreover, we are advised that the registration process itself takes many months.

Money management is a highly competitive business. Certain of our competitors, banks and trust companies, are excluded under the statute from being CTA's. Accordingly, they are not subject to the very considerable expense, inconvenience, and delay involved in CTA regulation.

We submit that for these reasons, the Congress should add a further exclusion to the definition of a commodity trading adviser for any SEC registered investment adviser whose advice concerning futures is in connection with the management of securities portfolios for institutional clients.

As an alternative, the committee could, in its report, include a specific recommendation that the CFTC promptly move to grant such relief under its present power to exempt persons from the definition of a CTA.

Thank you for the opportunity to address the committee today on this very important topic. I would be happy to answer questions that I can. If the committee has any questions on the legal points made in our statement, I will refer to Ms. Field or to Jeffrey Martin, a member of the law firm of Shea and Gartner.

[The prepared statement of Mr. Brookmeyer appears at the conclusion of the hearing.]

Mr. JONES of Tennessee. Thank you very much, Mr. Brookmeyer, for a statement that we will certainly take a good look at.

Now, that concludes the testimony from the panel. At this point, I yield to the ranking minority member of the subcommittee, Mr. Tom Coleman, for any questions he might have.

Mr. COLEMAN. Thank you, Mr. Chairman.

Mr. Gilmore or Mr. Donovan, could you describe what you see as an accuracy rate of your CTR system as you now have it, I guess, or you envision it? Where are we on this?

Mr. GILMORE. As proposed, Mr. Coleman, it will be very difficult for me to give you a hard, fast number today because a certain segment of the system does not exist. I can tell you what the system is going to do. However, in reality, I cannot give you a hard, fast percentage and say it is 89 or 91 percent within 1 minute.

The Commission has said that 1 minute is the standard that we should aim for. We have, however, produced the ability to do the following: The next morning, we will be able to tell the Commission who did what, how much, at what price, with whom, by whom, and at what time. That ability to reconstruct trade is what we focused on for the entire intellectual endeavor.

Can I tell you now that it is going to be 85 or 95?

No, sir; I cannot.

Mr. COLEMAN. Yesterday, it seems to me that there seemed to be a spirit of compromise in the air. I don't know if you all were here yesterday or not, but your colleagues from the Merc were and represented your positions. We had testimony from the Chairman of the Commission yesterday in which we thought we were hearing some comments that were trending toward working this out for a solution. We also have a letter in the record from the Chairman to Senator Lugar in which in writing the expression of coming together on this issue appears to be possible.

I am a little taken aback by your statement today, though, which seems to give us an impression—and if it is a wrong impression, please change that—of a kind of take it or leave it attitude this morning. Is that an impression that I am wrongly receiving?

Mr. GILMORE. I may have communicated it poorly. It is not a take it or leave it attitude on the part of the Chicago Board of Trade. This endeavor has caused three-way cooperation between the CFTC, the Chicago Mercantile, and the Board of Trade. The one remaining piece, in my opinion, would be that we have to commit a significant amount in dollars and time. I would like a clear-cut go-ahead, and maybe that is a desire that I will never attain.

Mr. COLEMAN. If the written proposal which we were given a copy of yesterday, along with apparently oral statements and conversations that the exchanges have had with the Commission and staff, are incorporated in the proposal and then yesterday, I think Mr. Melamed said that they wanted to run that with actual figures in there as soon as possible, I guess, as a display to show its accuracy and so forth, then it would seem to me that if all parties to this could deal in good faith as much as that is possible and in the spirit of cooperation, then I think that your concerns may dissipate as we come forward to a final decision on this.

I don't think the Commission would want us to feel that they were not trying to work with the exchanges, and I think the exchanges recognize that we want to resolve this issue. Mr. Jones and I both yesterday stated that we wanted to utilize these hearings as a facilitator in that regard.

So, I hope that will be the case, and it is possible that we can resolve this issue before we have to mark up a bill here in the future.

Mr. GILMORE. I think it can be resolved. Insofar as supplying it or resolving it by the end product, we are probably talking about a year's development time by highly sophisticated, commodity knowledgeable programmers, and they are a rare breed.

Mr. COLEMAN. In other words, you feel it would take up to a year for this system to come on track?

Mr. GILMORE. If you told us, if we as an exchange said on March 19, tomorrow we are going to go forward, I would think the minimum amount of time would be 9 months, and that is extremely optimistic, more realistically, a year. We not only have hardware and software considerations, but we have trading floor changes for our membership, things that have to be implemented, rules that have to be promulgated and approved by the CFTC. I would say the minimum time requirement for the entire package would be a calendar year from tomorrow.

Mr. COLEMAN. And have you communicated this to the Commission?

Mr. GILMORE. We have spoken in terms of a year, of 9 months. The Chairman has told us that if we are moving toward the goals that we mutually agree on which is a better audit trail that they would be considerate of extensions to the timetable that was promulgated on January 14.

Mr. COLEMAN. And you feel that is or is not an appropriate response?

Mr. GILMORE. I think that is an appropriate response. I don't think that we can, under the program outlined in the demonstration, we can't abide by the July, October, January timetable.

Mr. COLEMAN. Thank you.

Mr. JONES of Tennessee. Thank you, Mr. Coleman.

Now the Chair yields 5 minutes to Mr. Stenholm.

Mr. STENHOLM. Thank you, Mr. Chairman.

Mr. Lebeck, in your testimony, you indicated agricultural options have proven their usefulness and there is no longer a need of a pilot program and that they should be opened up. Does anyone at the table disagree with that or would like to further amplify on that statement?

[No response.]

Mr. **Stenholm**. I take it everyone agrees. No one indicates they disagree.

Mr. Gilmore, do you support H.R. 3434 and, if so, why?

Mr. **Gilmore**. We believe that H.R. 3434 and the CFTC's position both arrive at the same target. We do feel, though, that the provisions of H.R. 3434 are much clearer, cleaner, and allow for a phaseout period of 2 years for the two affected firms. Therefore, the favorable solution to the thorny leverage question, in our opinion, is H.R. 3434.

Mr. **Stenholm**. Mr. Feigan, would the States have jurisdiction to regulate the leverage companies under their blue sky laws if leverage regulation was not preempted by the Commodity Exchange Act?

Mr. **Feigan**. Yes, sir; I believe they would. Prior to the enactment and effectiveness of the Commodity Exchange Act, when the leverage companies started selling their contracts, several States brought actions against the companies or took enforcement action against the companies and went to hearing or trial regarding them. One case in particular I am aware of was the American Corn Exchange case in Wisconsin where the leverage contract was analyzed and declared to be an investment contract security within State jurisdiction.

So, I believe they would be able to be regulated as securities under State law.

I also would add that they would probably have great difficulty becoming registered under merit statutes because of their structure. So, in essence, they might be securities that would not be able to be lawfully sold.

Mr. **Stenholm**. Mr. Gilmore, if Congress were concerned about a rumored manipulation of the price of a commodity traded on your exchange, what data could your CTR system provide about this situation and how quickly could it be provided?

Mr. **Gilmore**. The data would be all-inclusive data in our opinion. It would be—let me just go through an example that somebody sold an inordinate amount so I keep it all on one side. Who sold what, to whom, in what amount, at what time, and by whom—so the entire transaction from that sell side is available as to time, as to price, as to amount, period. It would be available the next morning.

Mr. **Stenholm**. To whom?

Mr. **Gilmore**. CFTC, as a self-regulatory organization and the Commodity Futures Trading Commission if they expressed a concern. It would be available the next morning. And to our business conduct committee.

The important thing to understand about our system is the system itself collects a pile of data. The ability then to sort that data is the uniqueness of the system. It is how we can apply it. If somebody wanted to know the trade that I did on the exchange floor the next day, they could sort it out all trades John Gilmore did, all trades John Gilmore did between 1 and 1:15, all trades

John Gilmore did with other people, a specific group of people on the other side.

So, not only can it provide who, why, what, when, and how, but then you can take all the permutations or what the computer programmers call iterations of who, what, why, when, and how and sort them backward and forward.

Mr. STENHOLM. And be available the next day in a printout form?

Mr. GILMORE. Right now, we believe we can produce it in either form. We certainly can produce it on a tube.

Mr. STENHOLM. Thank you.

Mr. JONES of Tennessee. Thank you, Mr. Stenholm.

Mr. Cooper Evans, you are recognized for 5 minutes.

Mr. EVANS of Iowa. Thank you, Mr. Chairman.

I would like to pursue somewhat further the audit trail subject. Mr. Gilmore, are you saying that for you to proceed with CTR, you would like to have it blessed at this point by the Commission and totally, regardless of what the end product will be able to produce, because of the relatively large investment that I know you would have to make in this? Can you expand a little bit on just what your attitude is?

It seems to me that it is not reasonable to ask the CFTC or this committee to say, hey, you have this concept here and we aren't really sure what it is going to do, but we are going to give you total assurance that whatever it will do and you can get out of it, it is going to be satisfactory in meeting the audit trail requirements.

Just what is your attitude on that subject?

Mr. GILMORE. I believe, Congressman, that the system that we propose gives us what we describe. If the system does not deliver it, if it does not deliver it in the manner as we proposed it, then I don't think anybody should approve it. I am not looking for a blanket if we commit the funds in time that this will be for all time.

Mr. EVANS of Iowa. That reassures me to some extent. I am puzzled by one of your statements, though. I got the impression you said you were going to be able to match all trades, and I don't think you are going to be able to do that, are you? You didn't really say that? You didn't mean to say that or didn't mean to imply that at all?

Mr. GILMORE. We match all trades now, but we don't match all trades to the minute.

Mr. EVANS of Iowa. That is right.

Mr. GILMORE. And this system would not be able to take 100 percent of the trades 100 percent of the time and reduce the time factor to 1 minute. The CFTC admits that. One Commissioner stated that in one of their hearings on this matter.

This system, in my opinion, will not impede the market but will produce a time record of a high degree of accuracy that exists on no other exchange where the human trading element comes into play.

Mr. EVANS of Iowa. I guess I am more interested in the subject of sequencing than I am of time. What comments do you have on the accuracy with which you could determine the sequence of trades?

Mr. GILMORE. By sequence you mean that if I did step one first and then step two and——

Mr. EVANS of Iowa. No. Who traded ahead of whom? Who followed behind whom?

Mr. GILMORE. If this is a case of a customer being disadvantaged, if you are meaning sequence customer versus independent trader, I strongly believe that we can establish a record that will ensure customer integrity and that will enable us to show that the customer was order was executed either before or after the individual's personal transaction.

Mr. EVANS of Iowa. Are you opposed to numerical sequencing of floor traders' cards?

Mr. GILMORE. No, sir.

Mr. EVANS of Iowa. How often would you pick those cards up?

Mr. GILMORE. I think we would begin on a once a day basis. The industry, however, already does it more frequently than that to stay ahead of the processing, but in some areas we would probably do it once a day and in other areas more frequently, depending on the activity of the market.

Mr. EVANS of Iowa. I think it would greatly increase our confidence that one was going to be able to reconstruct a true audit trail if the frequency with which those cards were retrieved were greatly accelerated, whether or not they were put into the computer at that time. Human nature is such that even if one has a large number of sequenced cards, if you have access to them all day long, you could do certain things if you wished to to use them out of sequence. I think this causes me some concern when you are trying to reconstruct the order of trades which I think is the key as opposed to the time in trying to reconstruct an audit trail.

Do you have any comments on that? How far would your floor traders be willing to go to really come clean on that particular point?

Mr. GILMORE. I think the system gets you where you want to go, but let me state that I agree with you entirely that I don't think time is the issue. Reconstruction or sequencing is the issue. If one understands the mathematical permutations of the computer search that goes on, for an individual to alter his trading pattern in an unrealistic manner after the trade, in other words, trying to justify x when he really did y, I don't think it can be accomplished.

I believe that there are so many mathematical derivations that come back, I could not possibly get all the parties that would interrelate and say, well, you better change this to this and that to that.

Mr. EVANS of Iowa. Well, I have never been a floor trader and you have, but I have some appreciation for it. I am inclined to agree with you, but I think that a lot of my constituents would still have some questions.

I thank you very much for your very responsive answers.

Mr. JONES of Tennessee. Thank you, Mr. Cooper Evans.

Now, the Chair recognizes Mr. Glickman who was here earlier and had to leave and has returned.

Mr. GLICKMAN. Was there any other member here before me?

Mr. JONES of Tennessee. Mr. Tallon did not have any questions, and he had to leave.

Mr. GLICKMAN. All right. Thank you very much. Thank you, Mr. Chairman, and I am sorry I didn't get to hear all the testimony of the witnesses, and I hope I don't repeat myself.

Mr. Gilmore, on page 7 of your testimony, you have a paragraph, the third paragraph, talking about the audit rule, you say

> Since so much is at stake to our markets, we must continue to ask Congress to revoke the CFTC's new rule unless the CFTC can give us the green light to proceed by confirming unequivocally that CTR indeed does comply with their new rule.

I wonder if you might amplify on that.

Mr. EVANS of Iowa. I asked the same question.

Mr. GLICKMAN. You asked the same question? Well, let me hear it again. Let me hear the answer.

Mr. GILMORE. I think the cooperation of the last 30 days has removed a great deal of that. We got down to, with Mr. Coleman, defining a green light. What would make us happy obviously would be a statement, a very positive statement from the Commission, that the system as designed gets us to the promised land.

We realize that this statement exists in theory only. We are very, very confident that the system can do what is required, especially when compared to other systems that the rule implies. The rule, to me, always implied 1 minute manual recordation, that there was no other alternative.

So, part of the green light is that this does not require manual recordation. It is a narrow interpretation of 1 minute versus reconstruction of audit trail question. Is 1 minute more important or is a good audit trail more important.

Mr. GLICKMAN. Well, did you ever get the impression from the CFTC, the clear, unequivocal impression, that 1 minute manual recordation is what they intended under this rule?

Mr. GILMORE. When I read the final rule on January 14, that is certainly what I believed.

Mr. GLICKMAN. How about from the staff and from the commissioners themselves?

Mr. GILMORE. At conversations after that, we got various degrees of reasonableness, and then it was what our definition of reasonableness is versus their reasonableness.

Mr. GLICKMAN. Where are you right now, today, other than in 1300 of the Longworth Building?

Mr. GILMORE. CTR right now, if we started today, 1 year from now we would have an up and going system. We would have expended time, effort, changed some trading systems, but we would present the Commission with an audit trail that, in my opinion as a member of three exchanges and I have traded on five during my lifetime, exists on no other exchange.

Mr. GLICKMAN. Where are you now vis-a-vis the Commission?

Mr. GILMORE. On the 2-yard line?

Mr. GLICKMAN. Who is offense and who is defense? [Laughter.]

Mr. GILMORE. We from Chicago honestly believe that not only the Bears but the Chicago Board of Trade is always at the leading edge of either football or technology in this matter, so we believe we are on the offense. We believe that when the final rule was issued, Congressman, and all levity aside, we had two courses open to us. We could have turned and said this is impossible, we can't do it, or we could go back to the drawing boards.

We have gone back to the drawing boards basically since January 14. I am talking about in a period of 2 months. I have never seen a cooperative effort between two Chicago competitors like I have seen between the Board of Trade and the Merc. I have absolutely spent more time with Mr. Melamed than I have with my family in the last 2 months.

Mr. GLICKMAN. Let me ask you a quick two additional questions, one on the leverage. I think Mr. Stenholm asked you this, but you do support——

Mr. GILMORE. H.R. 3434.

Mr. GLICKMAN. OK.

Mr. GILMORE. It gets us the same place the Commission wants to go. I believe it gets us there cleaner, more justly, and in a better manner.

Mr. GLICKMAN. And Mr. Feigan, do you agree with Mr. Gilmore in that statement?

Mr. FEIGAN. Yes; I do, although I believe that both proposals would achieve the same end.

Mr. GLICKMAN. Thank you. One final question, the Chicago Board of Trade has established an indemnity fund, I believe, which is I guess something similar to what the Mercantile Exchange has, a $30 million trust fund that has been going to provide basically capital account protection. I have been interested for some time in the issue of insurance for customer accounts, because those people who do business in the futures industry, customers, don't have the same insurance protection that if you do business in the securities industry you do under SIPIC.

I am not convinced that it is—the issues are slightly different and maybe we shouldn't move ahead with and insurance issue right now, but I wonder if you might comment on the insurance issue and also tell us a little bit about your indemnity fund and what you intend to do with it?

Mr. GILMORE. The Chicago Board of Trade Clearing Corporation, a separate corporation, has established an indemnity fund that, as of the close of business at the end of February, is approaching $10 million. This is from June of 1985 to date. We intend to continue to accumulate that fund to ensure the integrity of the contracts entered into in the case of a futures commission merchant failure.

The sole purpose of the fund is to guarantee those accounts. We believe very strongly that the record of not only the Chicago Board of Trade but the Clearing Corporation is one that we have always moved promptly, quickly, to move positions of customers to viable FCM's and out of the failing FCM. That is what the fund is intended to do.

If necessary, the fund will be applied to move the positions with monies that are entitled to be moved.

Mr. GLICKMAN. Do you intend this to grow in size?

Mr. GILMORE. This is growing at an unprecedented rate and much faster than we anticipated. I think the question yet to be debated, Congressman, is where we cap it.

Mr. GLICKMAN. Mr. Chairman, could I just ask one more question?

Mr. JONES of Tennessee. Certainly.

Mr. GLICKMAN. I just want to make sure that we are on the same wavelength on the audit rule. As I understand it, 17 CFR part 1, in connection with the final rule, they say:

> The rule has been amended to make clear that the actual time of execution need not be obtained by the trader himself but could be a time otherwise obtained that meets the Commission's performance standard and, in some cases, a single time for a transaction need only be obtained.

Is that in conformity with what you understand the current position of the Commission to be? That implies a little bit of flexibility.

Mr. GILMORE. Yes; that is. But if I read the rule 1.35g as stated, I gave it the other interpretation.

Mr. GLICKMAN. OK. This was in the summary.

Mr. GILMORE. My understanding today, March 18, is what you just read.

Mr. GLICKMAN. OK. Thank you, Mr. Chairman.

Mr. JONES of Tennessee. Thank you very much, Mr. Glickman. Mr. Lindsay Thomas.

Mr. THOMAS. I have no questions.

Mr. JONES of Tennessee. No questions. Does any other member of the committee have questions? Mr. Evans.

Mr. EVANS of Iowa. Might I ask one short one?

Mr. JONES of Tennessee. Surely.

Mr. EVANS of Iowa. I would ask the Chicago Board of Trade folks if you were faced with the sort of difficulties that developed in the London Metal Exchange recently on tin, could you handle it?

Mr. GILMORE. There is a key difference, Congressman. The London Metals Exchange had no clearinghouse, no bank, no general fund, collection of data, and no marked market. If we didn't have all those things, no, we couldn't handle it.

With the machinery involved, what happened in London will not happen on the Chicago Board of Trade. Significant amounts of money were owed to people. In Chicago, we pay and collect on those daily. Sometimes in the Government securities business in the last 10 days, we have collected and paid on those hourly. The Clearing Corporation during the 10 days immediately prior to last Monday collected over $4.4 billion.

So, no. Under London's rules, nobody could handle it. Under our rules, it wouldn't have happened.

Mr. EVANS of Iowa. Thank you very much.

Mr. JONES of Tennessee. Are you finished, Mr. Evans?

Mr. EVANS of Iowa. Yes, thank you.

Mr. JONES of Tennessee. Does any other member of the subcommittee have a question?

[No response.]

Mr. JONES of Tennessee. The Chair has no questions. Thank you very much for appearing, and we will reserve the right to correspond with you for any further questions that we might have.

Panel No. 2 will be heard next. Those witnesses are Mr. Louis Carabini, president of Monex International, Ltd., of Newport Beach, CA; and Mr. Harvey Kochen, vice president of International Precious Metals Corp., Fort Lauderdale, FL.

I would like to at this time urge the remaining witnesses to be as brief as you possibly can, because there was no afternoon session planned for today, and we would like to hear all the members this morning without a break if at all possible. But I don't want you to overlook anything that you really want to present.

Mr. Carabini, welcome. We are delighted you are here, and you may proceed.

STATEMENT OF LOUIS E. CARABINI, PRESIDENT, MONEX INTERNATIONAL, LTD.

Mr. CARABINI. Thank you, Mr. Chairman, and good morning.

My name is Louis Carabini. I am the founder and president of Monex International. Monex is a leverage transaction merchant registered by the CFTC and located in Newport Beach, CA.

I have testified on legislation to reauthorize the CFTC on two previous occasions and also at an oversight hearing on leverage transactions held here just 1 year ago.

I appreciate the opportunity to appear before your subcommittee again today. I am here to oppose the legislative proposals of both the CFTC and H.R. 3434 and also the recommendations of the futures exchanges who have testified to ban leverage contracts.

Monex was founded in 1967 and today employs over 200 people. Monex currently has about 14,000 active customers with whom it conducted over $0.5 billion in leverage transactions during 1985 alone. Since 1967, Monex has engaged in over $8 billion in leverage transactions with over 75,000 customers. During each of the last 4 years, we have averaged over 40,000 separate leverage transactions. Approximately 85 percent of Monex' transactions involve leverage transactions. The company also offers dealer options.

In 1974, Congress created the CFTC and, among other things, directed it to regulate leverage contracts. Finally, in 1984, after 10 years of conflict and inaction, the CFTC adopted comprehensive regulations to govern the leverage industry.

Two major companies were in this business prior to the creation of the CFTC. Today, 12 years later, the same two companies, Monex and International Precious Metals Corp., are the only companies licensed under the agency's new regulations. I understand the CFTC will consider the registration application of the only other eligible leverage dealer in the country. First Asset Corp. next week.

Together, we sought regulation. We finally got it. We complied and at great cost, I might add. Since 1984, Monex has spent over $1.4 million to meet its new regulatory obligations.

Twenty-three months later, the CFTC wants you to ban the very product and business practices we just changed in order to conform to their new requirements. Repeal of section 19 will outlaw leverage contracts, transactions molded by the CFTC's own definition, as illegal futures contracts.

What is the Commission's rationale for this proposal? Primarily, they argue that leverage contracts are really futures contracts and, therefore, must be traded on designated exchanges. But leverage contracts are fundamentally and legally distinct from futures contracts. I submitted a detailed discussion of these differences to the subcommittee last March, and I would be happy to do so again today.

Another issue the Commission has raised is one of inadequate resources to regulate leverage dealers. An easy solution exists. The National Futures Association could assume the job of primary regulator. Monex is already a member of NFA. This is also true of most, if not all, of those firms who would ever enter the leverage business. To the extent regulatory responsibility for leverage might increase NFA's operating costs, it could recover those costs directly through leverage member fees.

The major futures exchanges, which trade some of the same commodities Monex offers pursuant to leverage contracts, have also mounted a campaign to ban our business. Where were these exchanges in 1974 and in 1978 and in 1982? They sat right here and never once expressed concern over leverage contracts being futures contracts.

Moreover, for 10 years, while the CFTC refused to adopt comprehensive leverage customer protection regulations, they sat here in silence on that issue as well. Now that tough leverage regulations are in place, however, these exchanges urge that retail commodity customers must, for their own good, have investment opportunities restricted by law to exchanged-traded products.

Times have changed, Mr. Chairman, and this sudden interest by these exchanges just doesn't ring true. The financial press has reported that over the last several years, public customers have virtually disappeared from the futures markets. Troubled exchange leaders now ask you to believe that leverage contracts are somehow at least partly responsible and that an expanded leverage industry would increase the problems and destroy market liquidity.

Ironically, nothing could be further from the truth. If our business were banned, very few of our customers would speculate in the futures markets. Moreover, the CFTC regulations mandate, as a practical matter, that leverage dealers hedge the majority of their customer obligations on the futures markets. By covering obligations to its customers in the futures markets, Monex adds substantially to the liquidity of those markets. The value of our futures positions on Friday, March 14, for example, was $157 million, a typical position.

Healthy competition between substantial, well-regulated dealers would result in even more liquidity on the exchanges. The benefits of expanding this dealer competition would also include a much greater public awareness of lawful alternatives to the fraudulent boiler room schemes which flourish in the absence of legitimate competition.

If Congress were now to repeal section 19, the prospect of legitimate alternatives for these customers would disappear. By abolishing the stringent Federal regulations applicable to leverage transactions today, Congress would actually increase the problems of off-exchange fraud. Some States would continue to protect their citizens very well, others adequately, and most not at all. In short, you would ban the business of the only two companies in the country which have satisfied strict Federal regulatory requirements, and you would otherwise do nothing toward preventing the spread of off-exchange fraud.

Mr. Chairman, leverage contracts exist today to meet the investment demands of thousands of customers. These customers are well protected by an extremely restrictive program of Federal regulation. If the CFTC cannot, the NFA is certainly capable of handling day-to-day regulation of today's two-company leverage industry. It will be equally capable of regulating a leverage industry which could be cautiously expanded in the months or years ahead.

No new evidence exists to justify putting our companies out of business after all these years. All that has changed since 1982, when Congress last addressed this subject, is that strong regulations are finally in place.

Therefore, I urge you to reject the Commission's latest attempt to shed its regulatory responsibilities. Life might be a little bit easier at the CFTC, but that would be at the direct expense of thousands of members of the investing public and of the livelihoods of leverage merchants and their hundreds of employees.

The blandishments of the exchanges to destroy the leverage business should likewise be ignored; they are based upon anticompetitive self-interest. An effort to codify a monopoly over retail commodity customer transactions is reprehensible in its own right. When that effort is undertaken in the name of customer protection, it borders on customer abuse, itself.

Section 19 of the Commodity Exchange Act should be left unchanged, and Congress should direct the CFTC to lift its leverage moratorium.

Thank you, Mr. Chairman, for the opportunity to appear before you again today, and I will be pleased to answer any questions.

Mr. JONES of Tennessee. Thank you, Mr. Carabini. Your entire prepared statement will be made a part of the record if you overlooked anything in your oral presentation. And you alluded to the fact that you did submit some evidence about 1 year ago here. If you have a copy with you today, will you also submit a copy for the committee files?

Mr. CARABINI. I would be happy to.

Mr. JONES of Tennessee. Thank you.

Our next witness is Mr. Harvey Kochen, vice president of International Precious Metals Corp. of Fort Lauderdale, FL.

Mr. Kochen, welcome. You may proceed.

STATEMENT OF HARVEY KOCHEN, VICE PRESIDENT, INTERNATIONAL PRECIOUS METALS CORP.

Mr. KOCHEN. Thank you, Mr. Chairman.

Mr. Chairman and members of the subcommittee, my name is Harvey Kochen, and I am the vice president of International Precious Metals Corp. Thank you for this opportunity to address you today.

I have included with this statement an extended statement which I would request be included in the record.

Mr. JONES of Tennessee. Without objection, it will be made a part of the record.

Mr. KOCHEN. Thank you.

IPMC is a leverage transaction merchant registered under the Commodity Exchange Act. IPMC has approximately 200 employees in Fort Lauderdale, Boca Raton, and Newport Beach. We have been in the business of selling commodities on leverage since 1973. At the present time, IPMC has approximately 2,400 leverage customers.

I am here today because the Commodity Futures Trading Commission has proposed that Congress eliminate the regulation of leverage transactions from the act. It is the Commission's view that leverage contracts and futures contracts are legally and economically indistinguishable and, therefore, do not justify separate statutory treatment.

We oppose the Commission's recommendations.

I would like to make three points today: leverage contracts are not the same as futures contracts, the new leverage regulations are effective, and responsibility for regulating the leverage business is properly placed with the CFTC.

First, leverage contracts are not the same as futures contracts. There are clear legal and economic distinctions between the two. A leverage contract is an agreement to purchase a commodity from a dealer at a fixed price for later delivery.

A futures contract is an agreement to purchase a contract. Both the buyer and the seller margin their agreement with a performance deposit. It is designed primarily as a price hedging vehicle, not one for delivery.

Because leverage contracts and futures contracts are similar in many respects, they should have the same regulatory oversight. But because of their differences, they each require special statutory treatment to protect the public.

The fact is that a leverage contract is a distinctive retail product that is not available on the futures exchanges. Since the adoption of the CFTC Act of 1974, Congress has recognized the leverage contracts are different instruments from futures contracts.

Almost 10 years ago, in July 1976, a CFTC Advisory Committee on Market Instruments conducted a study of leverage transactions. After almost a year and several public hearings, the committee found that leverage transactions were sufficiently different from exchange traded futures transactions to justify the separate regulation of leverage contracts. The advisory committee proposed specific and comprehensive recommendations, and those proposals form the basis for the present leverage regulations.

The second point is that the existing leverage regulations are effective. The public is now protected in these regulated off-exchange transactions by rules that require: a minimal adjusted net capital requirement of $2.5 million; customer funds be segregated from the leverage merchants' funds; the leverage transaction merchant cover its obligations to its customers; and commodity customer safeguards that are unprecedented, such as the limited right of rescission for a first-time customer, the limited right of re-establishment without charges or fees of a liquidated undermargined position, and mandatory break-even disclosure to customers.

These rules require the registration of the merchant, its principals, sales personnel, the products, and the customer disclosure documents.

These rules are very effective. Customers are given proper disclosure, and they are protected from manipulation and fraud. The rules ensure the financial solvency of these transactions.

The leverage regulations have been in force since mid-1984. We have not had a single customer reparations complaint or civil litigation suit brought against us by a leverage customer whose account was established under the new leverage rules.

The third point is that responsibility for regulating the leverage business is properly placed with the CFTC. Leverage contracts are a variation of forward contracts and are similar to futures contracts. They are properly regulated as commodity interests under the act and subject to oversight by this committee through the CFTC. Congress has made this clear since 1974.

Federal jurisdiction has provided uniform and consistent regulation of these transactions.

If Congress withdraws leverage regulation from the Commodity Exchange Act, the regulated leverage transactions will become illegal. Our regulated leverage business will be destroyed because there are no existing State regulations within which to effectively carry out this business.

However, our customers and our market will still exist. Similar type instruments not subject to Federal regulation will be made available to meet this demand. The maze of various State regulations do not provide the protection now afforded by the existing leverage regulations.

The public will be better served by maintaining the existing Federal regulatory framework.

The burden upon the CFTC of direct regulation can be alleviated by transferring the direct regulation of the leverage industry from the Commission to a designated self-regulatory organization. The National Futures Association is the appropriate self-regulatory organization for that responsibility. They already supervise and audit futures commission merchants and other registrants. The cost of regulating the leverage industry would then be borne by the leverage industry itself through membership fees and transaction fees.

In conclusion, IPMC opposes the CFTC proposal that Congress withdraw leverage regulation. The facts are clear. Leverage transaction are different from futures contracts, and consumers want the alternative of leverage transactions. The new leverage regulations are effective, and the responsibility for regulating the leverage business is properly placed with the CFTC.

We request a settled regulatory atmosphere in which to conduct our business and serve the needs of our customers.

We urge you to maintain the existing regulatory framework for leverage transactions. It is unfair to put legitimate companies out of a legitimate business.

Thank you.

[The prepared statement of Mr. Kochen appears at the conclusion of the hearing.]

Mr. JONES of Tennessee. Thank you very much, Mr. Kochen.

The Chair now yields 5 minutes to the ranking minority member of the subcommittee, Mr. Coleman.

Mr. COLEMAN. Mr. Carabini, last year you said that you came here and testified and so did some other people on this issue. At that time, they gave 10 reasons why they felt that leverage should be regulated like futures, and I think it only fair to give you an opportunity to respond if you so desire or feel that you would like to now. If not, perhaps in writing, but if we might, we might go through here, because these are some of the things that were being said about your industry, and I would like to get your response if it is at all possible.

Mr. CARABINI. Mr. Coleman, I think maybe I can respond to some of these issues today. I would be very pleased if I could respond in writing, because some of these issues really require more extensive discussion.

Mr. COLEMAN. I understand. I want to be fair to you. I provided you a list a while ago, because in order to get a meaningful answer, I had to give you an opportunity to at least know where we were coming from on these questions.

Do you want to respond to those you feel you can right now?

Mr. CARABINI. Yes; I can respond to those. I can also respond to the issues that Mr. Feigan alluded to as to why leverage contracts should be treated as futures contracts.

And if I may go through this list first, since I wrote them down as he was speaking: that there is no economic value or no economic purpose or no validity to a leverage contract.

In our 19-year history, we have served 70,000 customers. Certainly, many of those customers are speculators in the market. Many of them were hedging against inflation, many of them hedging against other economic crises. If speculation is wrong, then it shouldn't be allowed anyplace, including the futures markets. I admit that most of our customers are hopeful of making a profit when they take a position in commodities pursuant to a leverage contract.

The second issue brought up was that there is no clearinghouse and, therefore, no protection. The first statement is correct. There is no clearinghouse mechanism in a leverage contract, but there is protection. We have always maintained a cover of 100 percent. Prior to the CFTC and in accordance with the California laws, because they had a commodity law in California, and with the new regulations, there is a requirement for cover, cover meaning the appropriate amount of commodity being held, either in physical form or in the form of futures contracts to cover the obligations to customers.

In addition, there is equity that must be segregated to equal or exceed the customer's equity every day.

The third issue was that prices are set by the company. This, to me, is very appalling, because every merchant in this country sets its price. It must be competitive in order to attract customers. We have been able to maintain a very competitive market, and my study that I provided this committee last year included two comparisons of our prices with other entities. I must say that comparing our prices over a 2-year period, which is a requirement, by the way, by the CFTC as a result of the new regulations, we compared our prices of silver bullion to Handy and Harmon prices. Over the 2-year period, there was a selected day of each month. The average differential in our prices to Handy and Harmon was 0.25 percent over that 2-year period, extremely close.

So, granted, we do set our prices, but we must maintain a competitive price, and that is why many of our customers repeat business with us, because 70 percent of our business is repeat business. I must say, 30 percent of our customers come to us as referrals.

That leads to the other issue that was made, and that is that our customers are unwary, that for some reason we are forcing them into buying commodities pursuant to a leverage contract. That is absolutely false. Our customers receive a disclosure statement of some 32 pages now required by the CFTC. Prior to the requirements of the CFTC, it was about the same length.

That disclosure provides all the information about the commodities they are buying pursuant to the contract, the risks involved in investing in any commodity. The customer must sign that document. After the customer has signed that document, we provide the customer with a verbal disclosure that is taped, outline the most important risks that the customer faces in buying commodities pursuant to that contract.

Also, according to the regulations, we must provide 3-day rescission. So, if a customer, on his first transaction, isn't happy for whatever reason, he can rescind that transaction.

They also pointed out the nontransferability, that for some reason because leverage contracts cannot be transferred to another dealer, for some reason there is something fraudulent about that contract. Granted, our contracts are not transferable, but the commodity that is purchased pursuant to that contract can be sold to any dealer in this country, and we would accept payment for any unpaid balance to accommodate a customer in the event he found a better price than our price.

Customers don't request it because our prices have been and are competitive.

He also pointed out that we are principals to the transaction. Granted, we are. That is one of the major differences between a leverage contract and a futures contract. We are the principal in that transaction. It is an agreement between Monex, in our case, and the customer, and it spells out the terms and conditions pursuant to which the purchase and sale of a commodity is made.

The last issue that he stated was the fact that we have a monopoly. For 10 years, I have asked this committee to open the leverage industry to competitors. I believe in a free market. I believe in competition, and if we are out there to compete, we must provide the customer with a good product at a fair price. I would welcome competitors into this business. I think it is far safer to have this business expanded than to be eliminated.

As I mentioned in my testimony, if leverage contracts were eliminated, where would our customers go? They will not go to the futures market. They will go to the scam operators and fraudulent operators that exist today. The repeal of 19 does nothing for those off-exchange instruments.

They are not claiming to be leverage contracts. If they did, they would have to register with the CFTC. They are not claiming to be futures contracts. Otherwise, they would have to be registered with the CFTC.

So, it would do nothing for the fraudulent and scam operators.

Here, we have operated legally for 19 years, 12 of those years under the CFTC. And to put us out of business because we have desired regulation and have complied with the law, I think, is deplorable.

I think those addressed the statements that he had made. There are some that are in this list that you gave me, Mr. Coleman, that are not included in his, and if I can glance through these very quickly—well, they refer to the 60-year statutory requirement that futures be traded on the exchange.

That is true, but if a leverage contract is not a futures contract, I think that question is moot. Leverage contracts are not futures contracts.

The other issue I think I might like to make relative to the No. 1 issue which is all off-exchange futures are otherwise prohibited is, I think, in this country, the commodity market or all markets are very dynamic. I think we should allow for the expansion of new types of instruments rather than restrict those instruments to only be allowed on a futures exchange.

Off-exchange instruments are prone to fraud. Granted, they are, but if they are regulated, they are not.

The third issue is leverage firms have a record of significant fraudulent and unlawful activity. There is a reference here to the fact that approximately 11 percent of all the customer reparations claims filed with the CFTC since 1980 have been directed at four leverage firms.

I would like to address that, because I think that is an issue that came up during the oversight hearings. May I point out that we did have an inordinate number of reparation cases filed during the rise and fall of silver in the early part of 1980. We have currently 12 open or pending reparation cases. Only 3 of those cases apply to the period time during which regulations have been in place.

It is my understanding that there are in excess of 800 total reparation cases pending before the CFTC. By my calculation, that is closer to 1.5 percent of the outstanding. If we related only to the 3 which relate to the period of time since the regulation, that percentage would be far less.

I must say, during the last 2 years, with only 3 reparation cases pending, we have conducted 70,000 transactions with over 25,000 customers. I think that is a pretty good record.

I can continue down this list. I see this red light.

Mr. COLEMAN. Well, I don't know.

Mr. JONES of Tennessee. There is no problem.

Mr. COLEMAN. If you have a chance to respond in writing—some of these you have already gone over in your response to the questions that you noted. I think you have hit the ones that I wanted a definite response on.

[The material follows:]

MONEX'S WRITTEN RESPONSES TO EXCHANGES' REASONS TO BAN LEVERAGE

Certain futures exchanges have issued a document which contained a section titled TEN REASONS WHY LEVERAGE SHOULD BE REGULATED LIKE FUTURES. The following is Monex's response to the exchanges' position on each of the reasons they give.

1. All off-exchange futures are otherwise prohibited.

Exchanges' Statement:

> The sixty-year statutory requirement that futures be traded on an exchange is essential to the regulatory scheme for futures trading. Congress has wisely concluded that futures contracts will serve their important economic purposes hedging and price basing -- only when traded under vigorous exchange self-regulation, subject to federal government oversight. Leverage represents an unjustified exception to this longstanding principle.

Monex's Response:

The conclusion drawn by the exchanges presupposes that a leverage contract is a futures contract. The exchanges provide no factual support to establish the basis for their conclusion.

Whether or not a leverage contract transaction is more akin to a futures contract, a cash transaction, a spot transaction, or a security depends on whom you ask. Exchange members take differing views as do the current commissioners of the CFTC. The CFTC Advisory Committee (a blue ribbon committee of lawyers, accountants, exchange members, members of the commission and academicians) concluded in 1976 that a leverage contract was legally and fundamentally different than a futures contract. That committee compared 26 significant elements of these contracts and found that only 3 were similar, 21 were different, and 2 were unclear.

Leading academicians, such as Dr. Houthakker of Harvard University, Dr. Hieronymus of the University of Illinois, Dr. Gray of Stanford University, and Drs. Harlow and Teweles of California State University have all concluded that a leverage contract is not a futures contract.

It is clear from the testimony provided to the Committee that leverage contracts do not serve an "economic purpose" as that phrase is defined under the Commodity Exchange Act and CFTC regulations. They are not used by commercial hedgers, for example, nor are they used to discover prices. While leverage contracts have no commercial utility, they offer a viable means for public customers to finance the acquisition of precious metals, as well as to speculate in precious metals for personal investment purposes.

Leverage cannot represent an unjustified exception to the longstanding principle as suggested by the exchanges, since a leverage contract is not a futures contract. Even if a leverage contract were a form of a futures contract, it does not mean that different regulations to protect the public would not be a more viable alternative to banning such activity.

2. Off-exchange instruments are prone to fraud.

Exchanges' Statement:

In the absence of self-policing, Congress has correctly feared that the public would be subjected to commodity transactions offered by bucket shop operators and con artists. Every recent scandal involving commodity-type instruments and substantial customer fraud had occurred in connection with the offer and sale of instruments not traded on CFTC-designated exchanges (London options in the 1970's; precious metals frauds in the 1980's).

Monex's Response:

The exchanges have time and again tried to use this self-righteous statement in order to mislead Congress into believing that every transaction outside of an exchange is fraught with fraud, while an exchange is free from such possibility. While there is potential for fraud everywhere, the fraud indicated in the exchanges' statement has nothing to do with regulated leverage transactions.

While certain commodity transactions not subject to regulations may be prone to fraud, it does not follow that banning regulated commodity transactions will have any remedial effect on such fraudulent activity. The elimination of regulated off-exchange firms such as Monex will leave the customer who wants to buy commodities such as precious metals and coins on a leverage basis no alternative but to seek the very firms who would continue to offer such unregulated transactions. This will lead to an expansion of the fraudulent activity and thus create the need for greater enforcement activity on the part of the state and federal agencies.

An expanded, well-capitalized, regulated off-exchange industry will not only provide such customers with the products and services they are seeking on a competitive basis, it will also make the public aware and cautious of the fraudulent activities.

3. Leverage firms have a record of significant fraudulent and unlawful activity.

Exchanges' Statement:

Approximately 11 percent of all customer reparation claims filed with the CFTC since 1980 have been directed at the four leverage firms. CFTC reparation decisions also reflect a long list of adjudicated frauds by leverage firms. The CFTC's Enforcement Division has brought at least one proceeding against each leverage firm for unlawful misconduct. Thus, leverage represents yet another example of off-exchange commodity fraud that underscores the wisdom of Congress' requirement that futures contracts be traded on exchanges.

Monex's Response:

The conclusion the exchange would like the reader to believe is that leverage contracts are inherently fraudulent. The CFTC, in their study, specifically concluded otherwise some years ago. The exchanges' figures are misleading because they include non-regulated and unlicensed companies. The facts: a large number of complaints were filed against Monex as a result of the unprecedented rise and fall of silver prices during the early part of 1980 (approximately 70 percent of the cases filed against Monex resulted from this period).

Of the two licensed companies, CFTC statistics show that leverage customer complaints comprise approximately 2-1/2 percent of their current reparations docket (20 pending cases among the 800 in the CFTC's Office of Proceedings, on assignment to administrative law judges, or on appeal to the Commission). In the last three years, there were 1,892 reparation complaints filed with the CFTC. Of those, 72 complaints involve the two registered leverage merchants, or 3.8 percent of the total complaints. Currently, Monex has 12 reparation matters pending before the CFTC. Only five cases (two of which have already been settled) have been filed relating to the two-year period since the new regulations have become effective, during which time Monex has engaged in over 70,000 transactions with over 25,000 customers. There have only been two reparation cases ever argued successfully against Monex since the inception of the CFTC, for a total of $40,000. Monex believes this record is better than any major FCM.

4. Leverage contracts are purely speculative instruments; no hedgers use leverage.

Exchanges' Statement:

Leverage firms readily admit that no commercial hedgers trade leverage contracts; leverage firms sell their contracts only to speculators. In futures, where hedging is prevalent, speculators assume the price risks hedgers seek to avoid. In leverage, where hedgers do not exist, leverage speculators do not assume price risks for anyone, but merely provide income to the leverage firms. Congress traditionally has expected futures contracts to serve a hedging or economic purpose. Leverage serves none and should not be tolerated.

Monex's Response:

The exchanges are correct in stating that leverage firms do not have commercial hedgers as customers. However, the exchanges are incorrect in their conclusion. Whenever anyone assumes the price risk of a commodity, it has to be assumed from someone. It does not matter if it is in the futures market or cash markets. There is no less a transfer of risk in a leverage contract than in a futures contract.

The customers do not come to Monex merely to provide the company with income. The customers come to Monex for a variety of reasons, which include the ability to make a profit and to hedge against a monetary crisis.

5. No CFTC rules prohibit leverage manipulation, although all leverage prices are inherently artificial.

Exchanges' Statement:

Leverage prices are fixed by the leverage firms to ensure their profits, and are not an accurate reflection of supply and demand factors. Exchange-traded futures prices are set by the market, based upon an open and competitive outcry auction. If a futures trader had dominant market power and intentionally used that power to create an artificial price, the CFTC could charge the trader with price manipulation. Under CFTC rules, however, a leverage merchant is free to do the same thing every day.

Monex's Response:

Every merchant establishes a price for his goods or services which is low enough to attract customers and high enough to make a profit. The exchanges would conclude that every non-exchange price is inherently artificial -- another ridiculous overstatement. In addition, the exchanges do not cite a single LTM's price which was not competitive with world market prices. In fact, Monex has never had a customer complaint filed which charged that Monex's prices were not competitive.

The CFTC regulations require a price series study comparing the LTM's prices for each commodity with that of a well-recognized quoted source. For example, the two-year average variation (weekly prices) for silver bullion, when compared to Handy and Harmon prices, was 1/4 of 1 percent.

The commodities offered by Monex are available from almost every coin dealer (over 1,000 in the U.S.), numerous banks and brokerage houses. Since Monex's leverage prices are equivalent to its cash prices, the customer can easily compare Monex' prices with any of a number of other sources.

6. Leverage contracts are subject to fewer regulatory safeguards than futures.

Exchanges' Statement:

Before authorizing trading in a futures contract, the CFTC requires an applicant futures exchange to submit an elaborate demonstration of its ability to regulate trading and the economic purpose of the contract. Leverage contracts are not required to make a similar showing, nor could the leverage firms demonstrate any economic benefit to their contracts. Leverage contracts thus enjoy a competitive advantage over futures contracts.

Monex's Response:

CFTC Chairman Phillips testified in March that the current leverage regulations are stringent and effective in providing good customer protection.

(See attached "Summary of CFTC Leverage Customer Protection Rules and Procedures".)

7. The CFTC has neither the resources nor the traditional expertise to regulate leverage.

Exchanges' Statement:

The CFTC's primary regulatory mission is to oversee the self-regulatory programs and operations of the exchanges. Since leverage is traded off-exchange, no comparable self-regulation exists; instead, the CFTC must engage in expensive and burdensome direct regulation that saps the agency's resources. If the CFTC is directed or decides to lift its moratoria, new firms may flock to the leverage business and further drain the CFTC's limited resources. Although the CFTC's existing leverage rules are well-meaning, the agency's ability to administer and enforce successfully these rules for an expanded leverage industry is, at best, doubtful.

Monex's Response:

Monex agrees with the exchanges that a self-regulatory organization such as the NFA would provide excellent assistance to the CFTC in regulating an expanded leverage industry.

8. Reported leverage abuses undermine the CFTC's credibility and tarnish the legitimate futures industry.

Exchanges' Statement:

Press reports and editorials have recently addressed the public protection problems in leverage. This media attention weakens the CFTC's reputation as an effective regulator and taints legitimate futures trading. Public, and even media, perceptions do not distinguish leverage firms from legitimate futures contracts.

Monex's Response:

This self-righteous attitude is a further example of why the exchanges' only motive in banning all off-exchange business is the fear of competition. If the exchanges are truly concerned about anyone's reputation, then possibly they should begin by looking closer to home. Many of the articles to which the exchange refer do not distinguish between legitimate firms and those operating fraudulently. In some cases, the most outrageous press editorials have been those authored or induced by representatives of the exchanges. If any confusion exists, it is the result of the exchanges who have promoted the confusion by not distinguishing between regulated and unregulated transactions.

9. Removing the leverage moratoria may create a widespread over-the-counter futures market.

Exchanges' Statement:

Historically, Congress has never permitted an over-the-counter futures market because of its fear that such a market inevitably would attract boiler room operators who would deceive and defraud the public. Congress also recognized that a non-exchange market could disrupt the efficiency and accuracy of the futures markets' price discovery-dissemination functions. For these reasons, Congress has directed speculators and hedgers to use exchange markets in order to channel and control their activities under the watchful eye of self-regulating exchanges. The unqualified success of exchange trading demonstrates that no reason exists to depart from the exchange trading principle now.

Monex's Response:

It is as illegal for an LTM to defraud a leverage customer as it is for an FCM to defraud a futures customer. Tough regulations are in place for just that reason. As stated earlier, Chairman Susan Phillips has testified that the regulations for leverage transactions are stringent and effective in providing customer protection.

LTMs do not disrupt the efficiency and accuracy of the futures markets, because they cover a significant portion of their customer positions in the futures market. Since customers of an LTM are not attracted to the futures market, the LTM provides additional liquidity on the exchanges as a result of the LTM's requirement to cover.

10. State law should apply to leverage firms.

Exchanges' Statement:

Once leverage firms are precluded from selling leverage contracts over the counter, these firms may restructure their instruments as cash or forward contracts. As such, the firms' retail activities would properly be subject to the full panoply of state law and regulation.

Monex' Response:

The exchanges' last reason to ban leverage is based on the assumption that the banning of leverage would not put the leverage firms out of business.

Approximately 85 percent of Monex's business is in leverage contracts. Monex does not know if any of the instruments suggested by the exchanges would appeal to its customers or serve the needs currently fulfilled by their leverage positions. Furthermore, while the Model Commodity Code of the State Security Administrators Association would apparently permit some forms of dealer-financed transactions, the code has only been adopted in three states: Missouri, New Mexico, and Washington. In other states it is unclear whether these alternative forms of dealer-financed transactions would be permissible.

SUMMARY OF CFTC LEVERAGE CUSTOMER PROTECTION RULES AND PROCEDURES

1. Minimum adjusted net capital requirement - $2.5 million

2. Cover requirement:
   - At least 90% of LTM's customer obligations must be covered with either physical commodities or futures contracts

   - At least 25% of LTM's total obligations must be covered with physical commodities

3. Financial recordkeeping and reporting requirements:
   - current financial books and records
   - formal monthly computation of adjusted net capital
   - quarterly CFTC filing of financial reports
   - annual fiscal year-end report certified by independent public accountant

4. Customer fund segregation requirement:
   - LTM must segregate customer funds from its own funds, (but may use customer funds to purchase cover, also held in segregation)

5. Disclosure requirement:
   - customer must receive, read, and return written acknowledgment to LTM of comprehensive disclosure document prior to entering into first transaction

   - document must disclose risks involved, all charges related to leverage contracts, background on firm and principals, and break-even calculation to advise customer of amount of price movement necessary in order for his position to be profitable (not required of futures)

6. Transaction recordkeeping and reporting requirements:
   - leverage transactions time-stamped to within nearest 10 seconds (absolutely chronological audit trail maintained for leverage transactions)

   - confirmations issued to customers within 24 hours of transactions, and monthly statement issued to customers regarding account status and activity

   - monthly volume and quarterly profit-and-loss reports to Commission

7. Antifraud and miscellaneous customer protection requirements:
   - LTM must make repurchase market whenever offering new contracts

   - customer may rescind 1st transaction within 3 days

Mr. COLEMAN. The chairman indicated you have testimony with you that you left with us last year. I don't know if you have it or your counsel has it.

Mr. CARABINI. I will either have it or my counsel has it or we will get you a copy.

Mr. COLEMAN. OK. Thank you.

Mr. CARABINI. Thank you, Mr. Coleman.

[The material is printed in the hearing held March 20, 1985, entitled "Regulation and Trading of Leverage Contracts and Dealer Options" Serial No. 99-3.]

Mr. JONES of Tennessee. Thank you, Tom, and thank you, Mr. Carabini.

Mr. Glickman, you are recognized for 5 minutes.

Mr. GLICKMAN. Thank you very much.

Mr. Carabini, I appreciate your testimony today. I think the issue here is not the integrity of either one of your two firms. Neither I nor do I think my colleagues have any question about your integrity. And I don't think anybody here on this committee wants to put Monex or, Mr. Kuchen, your firm out of business.

I think the question is, or at least it has been my question all this time, is making people play by the same rules. I guess if you go back to the base underlying question, are we talking about issues that are futures contracts? Are leverage contracts really futures contracts? If they are, then the congressional intent is that they should be traded on an exchange, clearly. It is unambiguous. That is the intent of Congress.

If they are not futures contracts, then we are talking about a whole different story that should be subject to a different kind of regulation.

The CFTC, the State Securities Administrators, they believe that you are futures and ought to be traded on an exchange. Now, their views are perhaps more credible on this issue even than the exchanges' because one could argue the exchanges have perhaps a proprietary interest in their position.

First of all, I want you to respond to basically what I have just said. Two, because Congress has to be the final arbiter as to whether these items are futures or not, how do you respond to the fact that if it looks like a duck and acts like a duck, it is a duck regardless of what we call it? In this case, the duck is a futures contract.

Mr. KOCHEN. I would like to make a comment on that. Congressman Glickman, the act recognizes off-exchange and on-exchange options. In private, when we have tossed this around ourselves at the company, we have always been bewildered, and we have been tempted to say, and so what? Let's say it was, and we don't agree that it was, we believe there is room for an off-exchange instrument for forward delivery, and we have always viewed futures contracts as a variation of a forward contract. We have always viewed futures contracts and leverage contracts as different kinds of forward contracts.

So, to us, the duck is not the futures contract but the forward contract.

The exchanges would have you believe that because of the price discovery issue that all business must be on the exchange or else it is impacting their business. Yet, we know that big business is done off-exchange.

When you are a regulator, and I know these examples can come back to haunt you, when you are a regulator, you look at fruit. Apples and oranges can be fruit. When you are the person it or the person baking the cake, there is a big difference between an apple and an orange, and there are a lot of similarities.

In terms of our market, in terms of our company, in terms of if you look at the actual regulations, there is a big difference between a leverage contract and a futures contract. So, we feel that there is a legitimate need and demand for the off-exchange commodity of a leverage contract.

Leverage contracts are purchases of commodities pursuant to a standardized agreement between a customer and a dealer. There is no trading of contracts. That is a misnomer. We don't trade contracts. We sell commodities under a standardized agreement between ourselves and the customers, like someone buys a purchase order, buys something pursuant to a purchase order where the terms are standardized. There is no trading of contracts. I mean, how could one really trade a contract to which one was a party?

Mr. GLICKMAN. Mr. Carabini.

Mr. CARABINI. You made the statement about a leverage contract, if a leverage contract is a futures contract, therefore we should all abide by the same rules. Well, there are, I think, two answers.

If a leverage contract is a futures contract, I don't think it follows that you have to be regulated by the same rules. Of course, we have taken the position that a leverage contract is not a futures contract, but even if we were to admit that it is a futures contract, can it not be regulated based on how that contract came about, the historical reasons for it?

The other I would like to point out, you had mentioned that the CFTC and certain other individuals have determined that a leverage contract is a futures contract. That is contrary, of course, to many other entities who have decided or come to the decision that it is not a futures contract.

One committee, in particular, that I would like to mention is the advisory committee, the blue ribbon committee formed by the CFTC shortly after it began. That committee was made up of members of the exchanges, the FCM community, the academic world, accountants, and lawyers, including members of the Commission also.

They made, in their report, a comparison of 26 what they called significant elements of a leverage contract, a futures contract, and a forward contract. Of those 26 significant elements, only 3 were the same, 2 they were unable to decide, and the balance, which was 21, were different.

Now, it was a very extensive study. I think it went on for over a year with many meetings, and reports have been made. So, I think from the onset it was determined that a leverage contract is not a futures contract, and nothing has changed since that time to make a difference or to make them similar. The contracts are essentially the same as they were when that study was conducted.

Also, I might point out that before this committee in 1978, the then-acting vice chairman of the Commission came before this committee and stated that a leverage contract was too dissimilar to a futures contract. It was more akin to a security and, therefore, suggested that they be relieved of the responsibility of regulating leverage contracts. It was only 1 year after that that they attempted to make leverage contracts, by edict, a futures contract.

Mr. GLICKMAN. One final question. What percentage of both of your businesses are in the leverage area and what percentage is in either direct sale of commodities or some other area?

Mr. CARABINI. As I stated in my testimony, about 85 percent of our business is in the leverage area. The balance is in cash and in options.

Mr. GLICKMAN. And you?

Mr. KOCHEN. For ourselves through the past year, just a tad less than half of our business was leverage business.

Mr. GLICKMAN. One final question, if possible. Maybe you touched on this in your statement, how do you make the market in the contract? Do you determine the market price and what is the markup that is charged? How do you compute your profit in this leverage transaction?

Mr. CARABINI. The price is determined based upon the review of prices of various commodities. We have, I believe, 22 different commodities which we sell pursuant to a leverage contract, and maybe the best way to answer that question, rather than go through any formula, because there really isn't a formula, market makers generally review and must act immediately upon whatever the prices are in the world markets. Our spread between bid and asked is about 2.5 percent, so our markup is about half that amount and our markdown when we buy is also about half that amount.

The commissions that we earn will vary between 1.5 percent to 2.5 percent on a purchase. Our other source of revenue includes any interest differential that we charge our customers versus the interest that we would be paying to either banks or as a result of future contracts.

Mr. KOCHEN. In our company, we in our disclosure document state what our pricing policy is, and it is an approximate 3 percent markup over our cost of acquisition. In exchange traded products, it is easy to get an exchange price, and you mark it up based on what your calculation of the spot price was. In products where there is a dealer market, for example, bags of silver coins, you would make several calls and get what you believe was a current price that you could hedge it at and then you would mark it up 3 percent over that.

Mr. GLICKMAN. Thank you.

Thank you, Mr. Chairman.

Mr. JONES of Tennessee. Thank you very much, Mr. Glickman. Thank you, gentlemen.

Mr. Cooper Evans, you are recognized.

Mr. EVANS of Iowa. I have no questions.

Mr. JONES of Tennessee. To either of you gentlemen or to both of you, I have a couple of questions I would like to ask. Why do you think that the futures exchanges have mounted such an assault on the leverage industry?

Mr. KOCHEN. That is a very good question, and I think that it is one of self-interest, that they are very concerned that very large FCM's would begin to get into this business. If you had the big FCM's doing futures business, like the Merrill Lynch Futures, et cetera, get into this business—and I remember I think it was the head of Merrill Lynch Futures testified last year, I think, in front of this committee. He said that they have been doing off-exchange business all over the world with no problem.

I think they are very concerned that this may be the crack in the door for off-exchange business. They would like all business to be through their doors. By opening up the door here, you may have large FCM's going and selling commodity interests to the retail public, and they may be able to do that without, as it were, having a piece—the exchanges would not have a whole piece of the action on that even though we do hedge substantially on the futures exchanges. I think it is the crack in the door that they view and they don't want to see opened.

Mr. JONES of Tennessee. Mr. Carabini.

Mr. CARABINI. Mr. Chairman, I would agree that the primary if not the only objective in the minds of the exchanges is to eliminate competition. I have discussed this issue with various members of the exchange, and they may come before this committee and have informed other people of the press that the main reason is customer protection. I have not heard one utterance of customer protection from any of these exchange members in any of our discussions.

We are more interested in customer protection than they are, because that is where we make our profit. And I am appalled that they have been able to persuade people into believing that they are more interested in customer protection when indeed I am convinced now that they have absolutely no interest in customer protection. It is solely competitive.

Mr. KOCHEN. The thrust of their arguments that off-exchange products are fraudulent, if they would address them to an oversight committee or a panel that regulated securities, they would be thrown out of the room, because the biggest business in the securities business is not on the exchange.

For them to with a straight face allege that off-exchange business is fraudulent is absolutely ridiculous.

And for them to argue that there is less regulation in these products than in futures for the small customer is absurd. If any of them would simply pick up a disclosure document of ours and compare it with all of the protection of the public there is here—the CFTC has really done a very strong job in protecting the consumer in this area. We have borne the brunt of it, and their arguments are incredible if you know what is going on.

I may say also that I appreciate this opportunity to talk in this way with you. So often, these formats don't let you. It is a straight question and answer. You don't have an opportunity to address what really is going on, and I appreciate the opportunity to address this subcommittee in this fashion.

Mr. JONES of Tennessee. Thank you, gentlemen. I have one other question that I would like to ask of either or both of you.

I would be real curious to know to what extent would you be able to reconstruct an audit trail on leverage transactions to a 1-minute compliance rule if it were applicable to your industry?

Mr. KOCHEN. We do it right now. We have been doing it for years. We do better than that, because we tape record the order on the type of 50-track machines that the conversations in the trading room are being taped. Besides that, we do the mechanical time stamping as well. That is one of the requirements under the new rules. Under the leverage rules, that is one of the requirements, 1 minute time stamping, and we have been doing that since April 1984.

Mr. CARABINI. Mr. Chairman, according to the new regulations, we are required as leverage transaction merchants to record those transactions within 1 seconds, and we have been able to comply with that requirement. In fact, we also provide for taping of the customer on line with the account representative and the trade desk so confirmation is immediate.

Mr. JONES of Tennessee. Thank you, gentlemen.

Are there any further questions?

Mr. GLICKMAN. Could I just ask one other question if possible?

Mr. JONES of Tennessee. Certainly.

Mr. GLICKMAN. If this Congress were to adopt either the proposal of the CFTC or the bill that I have introduced, what would the practical implications, the short-term and long-term implications, be on your business?

Mr. CARABINI. I can't answer that definitely. We have, of course, as a businessman, I have to look at the possibility of 19 being repealed, and here I sit begging before this subcommittee to stay in business. It is not the first time I have been before this subcommittee to beg, but here I am.

However, as a practical businessman, I have to look to other methods of providing service and commodities to my customers. We have had discussions with the CFTC over the past 6 or 7 months in an attempt to develop something that could be offered our customers that would be appealing to our customers and could be offered in compliance with Federal laws and the panoply of applicable State laws. We have not reached a conclusion as yet.

But let me say this. I think, Mr. Glickman, your bill provides for a 2-year phase or phasedown or whatever it is. As soon as that bill is signed, irrespective of the amount of time we are allowed to wind down, there is a whole in the ship. Customers are not going to deal with us knowing very well that we are going to be out of business in 2 years, that we cannot honor those contracts which, by the way exceed 10 years.

Our employees, particularly those with careers who have been there for a number of years, are going to look elsewhere.

So, it is not a matter of a 2-year phasedown. It is immediate. I am very concerned, as my employees are very concerned, and that is why maybe I am maybe a little bit more vociferous than normal before this subcommittee because it is our life. I am asking this subcommittee to look at section 19 and, at the same time, view the number of individuals that are involved in the event 19 is repealed.

Mr. GLICKMAN. Thank you.

Mr. CARABINI. Thank you, Mr. Glickman.

Mr. JONES of Tennessee. Thank you very much, Mr. Glickman, and thank you, gentlemen, for appearing here and giving us your ideas as far as reauthorization is concerned. We appreciate it very much.

Mr. CARABINI. Thank you, Mr. Chairman.

Mr. KOCHEN. Thank you.

Mr. JONES of Tennessee. The next panel is panel No. 3. The subcommittee members who are here feel that if you have no problems with flights out of here, it might be better to recess and come back at 2. Does anybody have a problem with that? There are so many things going on up here today that it is one reason we have an absence of subcommittee members. Does anybody have a problem with a flight this afternoon before, say, 4?

Mr. SELIG. Mr. Chairman, I have a problem simply from a workload point of view, but I would be happy to just leave my statement with the subcommittee. I am Steven Selig.

Mr. JONES of Tennessee. Would that be agreeable to you?

Mr. SELIG. Yes, sir.

Mr. JONES of Tennessee. If that is OK, then, we can accept that.

Mr. SELIG. Thank you kindly.

Mr. JONES of Tennessee. And the subcommittee will stand in recess until 2, then. Thank you.

[The prepared statement of Mr. Selig appears at the conclusion of the hearing.]

AFTERNOON SESSION

Mr. JONES of Tennessee. At the conclusion of the morning hearing when we recessed, we had just finished with panel No. 2. We are now ready for panel No. 3: Mr. Steve Wilson, commodity consultant, Evergreen, CO; Ms. Brooksley Born, attorney, Arnold & Porter, in Washington—I believe Mr. Selig had to leave; he is going to file his statement—and Mr. John P. Doherty, executive vice president, Illinois Cooperative Futures Co. of Chicago.

Lady and gentlemen, we are glad that you are here.

Staff has made a good suggestion here, Mr. Evans, if it is agreeable to you. We will just bring the other panel up, too, since we have lost Mr. Selig, and hear them all at one time if they are here and prepared: Mr. Merlyn Lokensgard, is he here?

Mr. LOKENSGARD. Yes, sir.

Mr. JONES of Tennessee. Mr. Reggie Wyckoff, marketing committee, National Association of Wheat Growers—Mr. Lokensgard is president of the Minnesota Farm Bureau representing the American Farm Bureau; and Mr. Steven Dreyer, Ohrenstein & Brown of New York. Are all of you here? Why don't you just come on up and join the crowd. We will hear all of you.

Mr. Wilson, commodity consultant from Evergreen, CO, is first on the list. If you are prepared and ready, Mr. Wilson, we would be glad to hear from you. We are glad you are here.

STATEMENT OF STEVEN M. WILSON, COMMODITY CONSULTANT, EVERGREEN, CO

Mr. WILSON. Thank you, Mr. Chairman, and members of the subcommittee.

My name is Steve Wilson. I live in Evergreen, CO. I entered the commodity business in 1973 in Chicago right after college. I started off as a runner on the floor of the Merc, as a phone man, and later became a member at the Mid-America, floor broker, floor trader. I worked as a broker for customers, I was an office manager, and I also worked for Payne & Webber.

Commodity futures trading has grown dramatically in the past 15 years. The surge in new contracts has broadened the economic base of this industry. The price discovery mechanisms when operating properly in a commodities futures market can provide producers and processors with an effective risk management system.

In our global economic community, the commodity futures markets will continue to grow and expand as they should. The commodity futures markets are a must.

The regulation of these markets has never been, nor will it ever be, a simple task. Whenever you have large amounts of money changing hands quickly, you will inevitably attract a certain percentage of individuals and firms willing to commit fraud. This fact of life is by no means limited to the commodity futures industry. But the commodity industry is one of the least regulated in the Western World. This fact makes the attraction to this industry even more sweet to those persons or firms seeking to defraud the public.

Those customers who feel they were wronged and seek to remedy the situation frequently discover, after the fact through their attorney, that there are only three avenues available to them. They discover that when they opened their account, they also signed a consent to jurisdiction next to a spot marked x. This clause forces the customer to bring his action in Cook County, IL, to hire a Chicago lawyer, to go through inordinate expense, and wait 5 to 6 years in the court backlogs of Chicago.

Brokerage house which insist on customers signing this "consent to jurisdiction" should only advertise, mass mail and cold call to residents within that designated jurisdiction. But if they solicit outside that jurisdiction, the actions should be brought in Iowa, Kansas, Texas, Colorado, or wherever they solicit.

The next available avenue which the customer discovers he has agreed to is arbitration. Arbitration has its place and can be a very effective method of resolving disputes, but never disputes involving fraud. There is little or no discovery permitted in arbitration. So, fraud can never be fully discovered or exposed. Arbitration should be maintained but should be consented to only after a dispute arises and never forces on a defrauded customer.

The third avenue available for remedy is through reparations at the CFTC. Here the action will be heard by knowledgeable administrative law judges. This, too, can be an effective method of resolving disputes. But like arbitration, the most a dishonest broker or his firm will be made to do is to give the customer his money back. But more importantly, like arbitration, there is little or no discover in reparation. Thus, not only is an ongoing fraud not exposed, it is camouflaged and allowed to continue.

If you have a cookie thief who has stolen 50 cookies, and you catch him with 1, and his greatest punishment is you make him put back that 1 cookie, he has profited by 49 cookies, and a new business soon flourishes, the cookie stealing business.

Arbitration, like reparations, must not be allowed to become an industry stop loss order on fraud liability.

For 500 years, Anglo-Saxon jurisprudence has relied on the collective wisdom of a jury to determine issues ranging from guilt or innocence in capital cases to complex antitrust matters. Why is this industry so afraid of having their conduct scrutinized by that same system?

I can think of only one reason, and that is they are afraid juries express the consciousness of the community, and they are afraid that their conduct cannot withstand that scrutiny. To avoid this scrutiny, the industry is trying to create a system which will insulate itself and allow them to thumb their noses at the laws that everyone else must adhere to. Adhering to good trading practices, they seek to limit their losses.

One result of this unique system is an arrogance that extends to some of the highest levels of the industry. In the matter of *Glen Hill* v. *Bache*, tried in Federal court in Denver, CO in March 1984, the defendant Bache retained John Frederic Troelstrup to testify as its expert witness. Mr. Troelstrup was former regional counsel for the Division of Enforcement at the CFTC, after which he became executive vice president in charge of law and compliance at the Chicago Mercantile Exchange.

As former head of law and compliance, Mr. Troelstrup testified under oath in Federal court that commodity brokers did not have to follow a particular law. After receiving a swift admonishment from Federal Judge James Carrigan, the judge turned to the jury and said, and I quote:

> I am going to instruct the jury to disregard any opinion this witness has given as to what the law is in this case. It is the obligation of the judge in a case to instruct on the law, and there is no such rule that anybody can disregard the law. Not in this country. I will instruct on that, if I am requested. But if you have gotten the impression that there is a right by anybody in this country to disregard the law, whether it is passed by Congress in a statute or by regulatory agency which has the force of law and its regulations, nobody has got the right to disregard that.

A copy of part of Mr. Troelstrup's testimony is attached to my prepared text for your examination.

If Mr. Troelstrup, with his background, believed that brokers don't have to follow the law, are we to expect commodity brokers to hold themselves to a higher degree of compliance than this industry giant? I think not.

I have never met a customer who understood the ramifications of consent to jurisdiction clauses or to arbitration. The question is not what type of person would sign away his rights, because they don't know they are signing away their rights. The question is more, what type of people would insist that you sign away your rights before your account is opened?

Arbitration should be maintained, but it should be agreed to and consented to only after a dispute arises, not before. If not, cookie stealing is going to become a very profitable industry.

Thank you.

[The prepared statement of Mr. Wilson appears at the conclusion of the hearing.]

Mr. **Jones** of Tennessee. Thank you very much, Mr. Wilson. If you will remain, you will have an opportunity to be questioned after we have heard all the witnesses.

Ms. Brooksley Born, attorney for Arnold & Porter, Washington, we are glad that you are here, and you may proceed.

STATEMENT OF BROOKSLEY BORN, ATTORNEY, ARNOLD & PORTER, ON BEHALF OF THE LONDON COMMODITY EXCHANGE LTD., THE METAL MARKET AND EXCHANGE CO. LTD., THE LONDON INTERNATIONAL FINANCIAL FUTURES EXCHANGE LTD., THE GRAIN & FEED TRADE ASSOCIATION, AND THE INTERNATIONAL COMMODITIES CLEARING HOUSE LTD.

Ms. **Born**. Thank you, Mr. Chairman, and members of the committee.

My name is Brooksley Born. I am a member of the Washington, D.C., law firm of Arnold & Porter, and I am submitting this testimony on behalf of the London Commodity Exchange, Ltd.; the Metal Market and Exchange Co. Ltd.; the London International Financial Futures Exchange, Ltd.; the Grain and Feed Trade Association; and International Commodities Clearinghouse, Ltd.

These clients are four London futures exchanges and the independent clearinghouse used by three of them.

Mr. Chairman, we have submitted written testimony, and we request that that written testimony be incorporated into the record.

Mr. **Jones** of Tennessee. Without objection, it will become a part of the record.

Ms. **Born**. Thank you.

These London exchanges believe that the U.S. Government should ensure that U.S. law and regulation should not extend outside the territorial boundaries of the United States in such a way that it violates international law. Such extraterritorial application of U.S. law creates unnecessary barriers to international markets and constricts international commerce.

For this reason, the London exchanges have strong concern about three provisions of the CFTC's proposed reauthorization legislation. A significant concern of the London exchanges relates to the proposed section 102 which would amend the Commodity Exchange Act to authorize the CFTC for the first time to serve a subpoena outside the United States upon a foreign national. The CFTC could thereby force the foreign person to appear in the United States along with his or her documents and to testify and produce the documents in any CFTC investigation or proceeding.

The proposed amendment would be a very significant extension of the current CFTC powers which are totally territorial. Indeed, it would be an exceptional and unwarranted extraterritorial extension of the United States subpoena powers generally. Even the Securities and Exchange Commission never had such extraordinary powers.

Extraterritorial service of subpoenas pursuant to section 102 would violate international law and would constitute an invasion of the sovereignty of foreign nations.

The British Government has sent a note to the State Department expressing its concerns about this provision.

Furthermore, if the CFTC were to use its subpoena powers under this proposed provision to serve a foreign person without sufficient minimum contacts with the United States, a serious U.S. constitutional issue would arise under the due process clause of the 5th Amendment. For these reasons, the London exchanges feel that section 102 should not be adopted.

The London exchanges understand that discussions on information sharing have begun between British and U.S. regulators. Cooperation between governments or regulatory authorities is the preferred route to information sharing and would avoid the international tensions that are likely to accompany adoptions of a unilateral action such as section 102.

The London exchanges also have a concern about the application of section 101 of the bill to futures contracts traded on foreign exchanges. Section 101 would extend the scope of section 4b of the act which currently relates to frauds in the United States exchange traded futures.

For the first time, section 4b would be extended to foreign futures traded on foreign exchanges. Less than 4 years ago, Congress adopted another provision of the act which relates solely and expressly to the offer and sale of foreign futures contracts in the United States. That section is a well considered, carefully drawn provision designed specifically to deal with fraud in foreign futures transactions.

The CFTC has not yet fully exercised its powers to adopt regulations under that new statutory provision and, indeed, is expected to propose such regulations next week. Yet, even before the CFTC has implemented the authority they asked for 4 years ago, they are asking for a second new statutory provision relating to foreign futures contracts without any explanation of why they need the additional provision.

The London exchanges feel that this provision is unnecessary as to foreign futures transactions and would be a less precise method of regulating them than current law. The language of section 101 should be, therefore, amended to make it clear that section 4b would not apply to transactions in foreign exchange traded options or futures.

Section 103 of the bill proposes the enactment of a new section which would provide the judicial review of a final order or rule of the CFTC may be obtained only in the United States Court of Appeals of a circuit in which the person seeking review either resides or has his principal place of business. By its terms, this provision would fail to provide any possibility of judicial review to a foreign person or entity which neither resided in nor had its principal place of business in the United States.

The CFTC today purports to regulate such foreign people, even if they do not reside or have a principal place of business in the United States, and to bar such interested foreign persons from access tothe U.S. courts for review of CFTC actions would raise serious questions under the due process clause of the Constitution.

Section 103 should be amended to grant judicial review to interested foreign persons.

On behalf of the London exchanges, I would like to express their appreciation for this opportunity to express their views on the CFTC's proposed reauthorization legislation.

Thank you.

[The prepared statement of Ms. Born appears at the conclusion of the hearing.]

Mr. JONES of Tennessee. Thank you very much, Ms. Born. We appreciate your testimony, and I assure you that it will be given fair scrutiny.

The next witness is Mr. John P. Doherty, executive vice president, Illinois Cooperative Futures Co. of Chicago.

Mr. Doherty, welcome. We are glad you are here, and you may proceed.

STATEMENT OF JOHN P. DOHERTY, EXECUTIVE VICE PRESIDENT AND CHIEF EXECUTIVE OFFICER, ILLINOIS COOPERATIVE FUTURES CO.

Mr. DOHERTY. Thank you, sir.

Chairman Jones and distinguished members of the Subcommittee on Conservation, Credit, and Rural Development, my name is John P. Doherty. I am executive vice president and chief executive officer of Illinois Cooperative Futures Co., a registered futures commission merchant. Incorporated in December 1960, Illinois Cooperative is an association of agricultural producers representing approximately 90 such entities which range in size from the largest regional cooperatives to small country elevator cooperatives. Our operation is limited almost exclusively to trading grain, grain products, grain futures, and grain options on behalf of the customers of these cooperatives.

Our customer base includes six futures commission merchants which are also regional cooperatives and two noncooperative grain export companies. in fact, the only speculative accounts carried by Illinois Cooperative are those of one of these member FCM's. In short, we provide the hedging facilities for every major cooperative in the United States and the provinces of Alberta, Manitoba, and Ontario in Canada.

We have, on occasion, been the largest single participant in the agricultural futures market, representing more open interest on the Chicago Board of Trade than any other firm in history.

We still hold the perhaps dubious honor of having received the single largest intraday margin call ever issued bythe Board of Trade Clearing Corp. on agricultural futures contracts.

I would also like to state that in our 25-year history, Illinois Cooperative has never lost a single cent due to a customer's default. Ninety-seven percent of our customers are on a wire transfer basis for margin calls. Our same-day collection performance on margin calls approaches 100 percent.

We, in turn, have established unsecured lines of credit with major commercial banks, totaling $50 million to cover these intraday margin calls and to ensure the proper segregation and protection of customer funds. Illinois Cooperative has never failed to repay a bank loan on the following business day. Certainly, commercial banks do not grant such lines of credit of this magnitude frivolously.

All in all, we are extremely proud of the financial integrity of Illinois Cooperative and the job that we have performed for American agriculture. However, if the CFTC's proposed amendments to the minimum financial requirements for futures commission merchants are approved as written, Illinois Cooperatives, as presently structured, will be unable to continue its operations as a futures commission merchant.

We agree that current CFTC financial requirements do not accurately assess the risk of futures or options positions held by a customer in today's environment. For example, if one customer as $1,000 on deposit with his futures commission merchant and no open positions, the customer poses no risk to the FCM or other customers. Nevertheless, the FCM is required to have capital of 4 percent of the customer's deposit, or $40.

On the other hand, another customer who also has $1,000 in his account and has multiple open positions creates a greater risk to the FCM and to the other customers. Yet, the FCM is assessed the same charge as required in the first situation.

Prior to 1978 and the implementation of the CFTC's existing capital requirements, minimum capital requirements were based on positions held by each individual firm. While not considered a concentration surcharge like that proposed by the CFTC last August, the principle was certainly the same. Capital requirements based upon positions held by an FCM is a more accurate measure of risk to an FCM and its customers.

The CFTC's proposed concentration charge, however, is unreasonable. Illinois Cooperative has calculated its net capital requirements for November 1983 using the CFTC's proposal. This was a period of high open interest and market volatility in the agricultural markets. If the Commission's proposed capital rule had been in effect at that time, Illinois Cooperative's members would have needed an additional $40 million in capital to comply with that regulation.

Illinois Cooperative has survived drought, corn blight, President Nixon's embargo, the Russian grain deals, President Carter's embargo, the Cuban blockade, the PIK Program, and the bankruptcy of several of our cooperative members, all without a single loss. But our ability to survive the Commission's proposed amendments to FCM capital requirements raises many questions as to our continued existence considering the current state of American agriculture and many of our farmer owners.

When the Commission's proposed amendments to the minimum financial requirements are reviewed in total, it appears to us to be a much more complex problem than first perceived by the Commission. We believe that the Commission proposed these amendments as a reaction to the default of the famous Volume Investors to rectify perceived inadequacies in financial requirements. But given the level of capitalization present in the industry today, the effect of these amendments would be to put a substantial number of FCM's, including Illinois Cooperative, out of business.

To do a truly thorough job of establishing minimum capital requirements, market risk and an FCM's ability to cover or absorb such risk must be reflected. It is our opinion that a complete review of the Commission's capital requirements is necessary, with a view toward basing capital requirements on the risk of open positions held by a futures commission merchant.

I would like to emphasize that protection of customer funds is the goal of not only the Commission, but of every responsible member of the industry. But adopting capital requirements is a delicate and a complex process. Not surprisingly, it took the Commission 3 years to promulgate its current capital requirements. Careful analysis had to be undertaken to ensure that no industry segment was unduly penalized.

Unfortunately, gentlemen, the present Commission undertook no such analysis before it announced the current proposals. Costs versus benefits were never considered. We strongly urge the Congress to direct the Commission to do this kind of basic homework before it puts the industry to the task of defending itself from regulatory annihilation.

Thank you, sir.

Mr. JONES of Tennessee. Thank you very much, Mr. Doherty, for your statement.

Our next witness is Mr. Merlyn Lokensgard, president of the Minnesota Farm Bureau and representing the American Farm Bureau Federation.

STATEMENT OF MERLYN LOKENSGARD, PRESIDENT, MINNESOTA FARM BUREAU, AND MEMBER, BOARD OF DIRECTORS, AMERICAN FARM BUREAU FEDERATION

Mr. LOKENSGARD. Mr. Chairman and members of the subcommittee, my name is Merlyn Lokensgard. I am president of the Minnesota Farm Bureau Federation and a member of the AFBF board of directors.

The American Farm Bureau Federation appreciates the opportunity to comment on the pending reauthorization of the Commodity Futures Trading Commission.

The Farm Bureau is an independent, voluntary organization of farm and ranch families united for the purpose of analyzing their problems and formulating action to achieve educational improvement, economic opportunity, and social advancement. We strongly support the reauthorization of the Commodity Futures Trading Commission.

Since one of the stated goals of the Farm Bureau is improving economic opportunity, we recognize the useful role that commodity futures and options trading plays in price discovery and in reducing certain types of market risk for producers of farm commodities. If the markets are to function efficiently with the full confidence of agricultural producers, the Commodity Futures Trading Commission, working with the exchanges and other industry self-regulatory organizations, must ensure market integrity through fair and effective trading rules that are enforced for all traders.

The Farm Bureau believes that the Commission is fulfilling this regulatory responsibility to producers and other market users.

The Farm Bureau would like to especially commend the Commission's Agricultural Advisory Committee for the role it has played in the agricultural community. The advisory committee has served as a sounding board to bring the views and concerns of producers and others in the agricultural sector to the Commission as well as an educational conduit to keep the agricultural community informed about the Commission's activities.

For instance, the committee was instrumental in helping the Commission develop rules for the agricultural options pilot program and in helping develop the Commission's final interpretation distinguishing cash and forward contracts and trade options involving farm products.

The Commission recently informed the advisory committee that it is considering allowing each exchange to trade more than the two farm commodity options that are currently permitted. Farm Bureau has no objection to expanding the current ag options pilot program provided the Commission is confident it can effectively regulate an expanded program that will benefit producers and others in the agricultural industry.

The American Farm Bureau also supports the Commission's audit trail rule which specifies a performance standard which requires each exchange to record the time each trade is executed to the nearest minute. The CFTC rule provides a reasonable, practical schedule of approximately 1 year for each exchange to develop its own accurate, verifiable system to comply with the audit trail rule.

The American Farm Bureau believes an accurate trade tracking system for all trades is mandatory if the Commission, as a regulatory agency, is going to effectively investigate allegations of manipulation, dual traders trading ahead of their customers, and other trading abuses which could threaten market integrity.

The integrity of the markets and the public confidence in those markets must extend to and include the price discovery function that the markets provide.

I want to deviate just a minute from my prepared statement. A week ago Monday, I was in Paris, France visiting with some French producers, some French leaders of the French farmers union. They asked me a question in the normal conversation, and they said, how reliable is the Chicago Board of Trades?

I related to them that with proper regulatory oversight, I have full confidence that the trades and the Chicago Board setting prices or being the price setter for commodities was a viable market. I think this is what we are talking about in Farm Bureau, the integrity of the market.

The 1985 farm bill mandated a marketing training program for farmers in the use of futures and options contracts. The program is to be carried out in a minimum of 40 counties across the Nation. Such a marketing training program could be useful in helping farmers gain experience in using futures and options contractions to hedge their price risk.

However, the American Farm Bureau would like to suggest a program with broader participation than the 40 counties originally authorized in the farm bill. The Farm Bureau has a market information program called ACRES in more than 30 States that could provide participants in the training program with marketing information and background.

Therefore, the American Farm Bureau encourages the USDA to form an advisory group that will include representatives of commodity and farm organizations that represent a broad membership and that can offer practical experience. The participation of the CFTC's economic and education units could also add useful perspective and experience to the advisory group.

Thank you, Mr. Chairman and other members of the subcommittee, for your time and your attention in considering these views. The American Farm Bureau is hopeful that the CFTC's reauthorization will proceed without delay while the Commission continues to work with the exchanges to resolve all outstanding issues concerning the new audit trail rule.

Mr. JONES of Tennessee. Thank you very much, Mr. Lokensgard. We will take a good look at your statement before we move ahead with reauthorization.

The next member of the panel is Mr. Reggie Wyckoff, chairman of the marketing committee of the National Association of Wheat Growers.

Mr. Wyckoff, we are delighted that you are here today, and you may proceed.

STATEMENT OF REGGIE WYCKOFF, CHAIRMAN, MARKETING COMMITTEE, NATIONAL ASSOCIATION OF WHEAT GROWERS

Mr. WYCKOFF. Thank you.

Mr. Chairman and members of the subcommittee, the National Association of Wheat Growers appreciates the opportunity to comment on the pending reauthorization of the Commodity Futures Trading Commission.

My name is Reggie Wyckoff, and I currently serve as chairman of the NAWG's marketing committee. I am a wheat producer from Genoa, CO.

As the primary organization representing the Nation's wheat producers, the NAWG seeks to improve economic opportunities for producers in a number of ways. One of those ways is to assist producers in understanding the grain marketing infrastructure so that they can better utilize it to maximize returns. Future markets are the foundation of our marketing system, offering a wide variety of marketing tools to meet the specific needs of grain merchandisers, warehousemen, processors, and producers. But in order for the markets to function properly, it is essential that those who use them are confident in their integrity.

The CFTC is charged with the important responsibility of ensuring the integrity of the markets by working with the exchanges to devise fair and effective trading rules and in enforcing the rules. The NAWG is confident that the Commission has carried out its responsibilities in a balanced manner and that producer concerns are adequately taken into account by the Commission.

An important aspect of producer participation in agency rulemaking has been the establishment of the agricultural advisory committee of which NAWG is a member. The advisory committee has played a particularly important role in the development of rules for the agricultural options pilot program now underway. The committee has also served to bring the views of affected industries before the Commission on a number of other issues, and it has encouraged discussion among interested parties.

Recently, the attention of the advisory committee and of the NAWG has been focused on the audit trail issue. The CFTC has proposed rules which would require exchanges to implement procedures which would provide an accurate and verifiable record of trade times to the nearest minute, including trades made between one floor trader and another. The successful resolution of this issue is important because exchanges must have the capability of discovering dual trading abuses which could harm the integrity of the market.

We have been very much interested in the technological advances made by exchanges in tracking floor trades, and we are hopeful that the systems now in place can be successfully adapted to meet the criteria set forth in the Commission's proposed audit trail rules package.

We understand the concern that exchanges have expressed in regard to maintaining liquidity during periods of high volume trading while complying with the Commission's proposed recordkeeping rules, and we would encourage the Commission to review the rules as necessary in order to meet these concerns. At the same time, we believe reauthorization proceedings should proceed while the Commission and the exchanges are in consultation to reach an understanding on compliance.

Educational initiatives for producers and others who utilize futures markets have been assigned a high priority with the NAWG as well as within the CFTC. The Commission's education staff has provi~~ded~~ invaluable assistance to the NAWG in planning educational seminars on a variety of issues, including commodity options.

When agricultural options were approved by the Congress and trading began within guidelines established by the Commission for the pilot program, it was important for producers to learn about the possible marketing opportunities provided by the options contract.

We believe education should be an ongoing objective of the Commission, and producers are not the only segment of the marketing chain that should be included in educational programs.

For example, it is not unusual for a producer who may be eager to expand his utilization of futures and option contracts to encounter opposition from his lender. Generally speaking, rural banks lack knowledge about the futures industry and have the attitude that hedging increases rather than reduces risk for the farm operator. Obviously, this group should be included educational programs sponsored by the Commission, as well as by the exchanges.

Others in the marketing chain, including the trading community, can help increase participation in the market by becoming more aware of their responsibilities to their customers and to the exchanges. Good understanding of exchange rules must be encouraged by the exchanges, as well as brokerage firms. Respect for existing trading rules and strong enforcement policies are the best means of preventing overregulation of markets, and the NAWG firmly believes that balanced regulations benefit both the exchanges and their customers.

Improving brokers' abilities to assess the financial capabilities of their customers will also serve to reduce overregulation. CFTC should continue to review existing capital rules to determine whether they adequately take into account the market risk of new trading instruments, such as agricultural options, as well as the overall risk of the financial environment in which futures markets function. But the Commission should be careful to assure that proposed capital rules does not overly disadvantage firms handling customer accounts.

The 1985 farm bill authorized the establishment of a training program for farmers in the use of futures and options contracts. The program is to be carried out through the USDA extension service and is to be operated in some 40 counties across the country.

Such a program could be very useful in giving farmers experience in using the markets, but the cooperative relationship between farmers and the extension service trainers must be carefully established to ensure that the objectives of the program are achieved.

Therefore, the work of the advisory committee will be very important in setting out program guidelines. The NAWG encourages USDA to take steps to form this advisory group and to include representatives of commodity and farmer organizations such as NAWG. Participation by the education division of the CFTC will also be important to the success fo the pilot program.

Although trading of wheat options has been relatively slow during this first year of their availability, we believe producer interest will increase with changing market conditions and as more is understood about fitting options into marketing plans. We have encouraged the Commission to expand the options pilot program so that additional contracts can be offered, including a wheat option on the Chicago Board of Trade as requested by that exchange.

The Commission has not identified any serious problems related to options trading and we believe a year has been a sufficient period of time to determine whether the pilot program should be expanded.

Thank you very much, Mr. Chairman and members of the subcommittee, for taking these views into consideration. The NAWG is hopeful that prompt action can be taken to reauthorize the CFTC for the 6-year period it has requested. I will be happy to respond to questions.

Mr. JONES of Tennessee. Thank you very much, Mr. Wyckoff, for a statement that we will take a real good serious look at before we mark up legislation.

Our final witness is Mr. Steven Dreyer, Ohrenstein & Brown, New York.

Mr. Dreyer.

STATEMENT OF STEVEN DREYER, MEMBER, OHRENSTEIN & BROWN, NEW YORK

Mr. DREYER. Thank you, Mr. Chairman and members of the subcommittee.

My name is Steven Dreyer. I am a member of the New York City law firm of Ohrenstein & Brown.

Having recently completed a 2½-year litigation on behalf of an investor who suffered a serious loss which resulted from an illicit dual trading scheme, I became keenly aware of the pressing need among the exchanges for the adoption and implementation of much more precise trade reconstruction systems. Accordingly, I would like to give the subcommittee a concrete example why such systems should be adopted in compliance with the audit trail rule.

The litigation to which I have referred is entitled *Dennis A. Herman* v. *T&S Commodities*. It is reported in volume 592 of the Federal supplement at page 1406.

The defense admitted in that case that Mr. Herman's account executive had engaged in unauthorized trading activities. The defense attempted to avoid liability on theories of ratification and estopel. Accordingly, the court's opinion did not address the mechanics of the scheme employed other than to note that it was undisputed that Mr. Sherman, the account executive, had engaged in substantial unauthorized trading in plaintiff's account.

However, the record revealed that prior to June 1982, Mr. Sherman, who was the vice president of the FCM in charge of his bank office operations, had suffered a loss in excess of $60,000 while trading for his own account. Despite the fact that his superiors had restricted him to trades not larger than one contract, Mr. Sherman attempted to recoup his losses by engaging in a blatantly fraudulent scheme.

On June 7, 1982, Mr. Sherman became aware that Dennis Herman had become a new customer of the FCM and had shifted a short position of 20 Comex September silver contracts from Bache to the FCM along with sufficient funds to cover the margin requirements. The very next day, Mr. Sherman began trading under a new account number which had not been assigned to any particular customer.

Throughout the first two-thirds of the trading day, Mr. Sherman amassed a long position of 50 Comex September silver contracts. When he realized that the market was not going to reward him, he entered short orders to reverse the positions. By the close of business, the still unnamed account held a long position of 21 contracts and had suffered a monetary loss for the day of approximately $7,300.

In order to avoid detection and the pecuniary loss of funds he did not possess, the account executive retroactively designated Mr. Herman as the owner of the account. After the close of the market, the account executive advised the investor for the first time that the foregoing trades had been made because, said the account executive, he thought it was a good opportunity for the investor.

The loss became much greater and grew into the hundreds of thousands of dollars as the market continued to move against the long position. Ultimately, when the investor learned that he had the right to disavow the transactions at no loss, he demanded rescission.

The litigation stemmed from the FCM's refusal to honor the demand.

During the course of pretrial discovery, I became painfully aware of the shortcomings presented by the 30-minute bracketing system employed by the Comex, especially in light of the testimony from many floor traders who advised the court that it was not unusual for trades to be recorded by the exchange as having taken place in time brackets which did not correspond to the actual times of execution.

Thus, as a litigator attempting to ferret out the true facts for presentation to the trial, I was presented with the difficulty of establishing the precise time when a trade was made so that all of the various documents which are there not only for the protection of the investor but also so that the CFTC can scrutinize and regulate and supervise the activities of the FCM's, it was almost impossible to prove with any degree of certainty the range of time for any particular trade, as recorded on the daily sheets produced by the Comex could vary by a factor of 60 minutes at a maximum.

Clearly, the adoption of and implementation of programs which comply with the 1 minute requirements of the audit trail rule would make jobs such as those which I had much simpler. It would also seem to be apparent that in the absence of rules such as the audit trail rule, there is really no reason for supervision, for there is only one person who really needs the protection of supervision, and that is the investor who relies on the exchange and, ultimately, the Commission to make sure that he will not be hurt in a manner such as the hurt suffered by Mr. Herman.

Thank you very much, Mr. Chairman.

Mr. JONES of Tennessee. Thank you very much, Mr. Dreyer, for your statement.

That concludes the witnesses, unless there is someone in the audience who has been overlooked. Is there anyone?

If not, Mr. Evans, the time belongs to you for questioning.

Mr. EVANS of Iowa. Thank you, Mr. Chairman.

First, I would like to compliment the two panels on their extremely good testimony. From my point of view, some of the specific points that have been raised are of great interest to me, and I can assure you I am going to pursue a number of them.

The time, I don't think, permits me to explore them in more detail here, but perhaps I will be in touch with you personally after the hearing.

I would like to visit at some length with Mr. Doherty. I thought you gave the best explanation of an alternative to the capital requirements rule that anybody has presented to this subcommittee, and your specific recommendations of base it on positions held I thought was very interesting. I think most of the other witnesses have said it ought to be on the basis of risk assessed in some manner, and I would agree with you that positions held has certainly got to be at least in part the basis for the risk.

Do you think other FCM's would agree with you on your specific conclusion? That is sort of presumptuous, I guess, to ask you.

Mr. DOHERTY. I would certainly hope so, sir. I think that position is not so far afield, if you will, that it cannot be, what shall I say, reviewed and discussed with some success.

Mr. EVANS of Iowa. One thing that comes to mind, however, is the volatility of positions held can be very great, as you know extremely well. It can jump all over the lot in just a few minutes or hours or certainly by the day. How would you smooth that out to make it manageable?

Mr. DOHERTY. Intraday margin calls, for one, sir.

Mr. EVANS of Iowa. OK.

Mr. DOHERTY. It has been a position of, I believe, just about all the exchanges for a number of years, and I think that earlier today in here our chairman was speaking about in here that the last, what shall I say, couple of weeks in here, there have been in Chicago intra-day margin calls per day in here.

Mr. EVANS of Iowa. This would multiply the effect of those margin calls, though, wouldn't it?

Mr. DOHERTY. Yes, sir.

Mr. EVANS of Iowa. Even more money would have to be marshaled and put into position very quickly based on your system.

Mr. DOHERTY. Yes, sir; that is true, but the protection of the customer is of extreme importance, not only to this committee and to the Congress, but to every responsible member of the industry.

Mr. EVANS of Iowa. But you think it would be manageable to do it that way?

Mr. DOHERTY. Yes, sir; I do.

Mr. EVANS of Iowa. Do you think it would be for some of the smaller FCM's?

Mr. DOHERTY. Yes, sir. That is a judgment call. It is a judgment call on my part.

Mr. EVANS of Iowa. Yes.

Mr. DOHERTY. It isn't going to be easy for any of us. The smaller ones, as I say in here, considering the agricultural economy today, but it is an answer, sir.

Mr. EVANS of Iowa. If I may, I would like to go to something else that I guess doesn't really bear on anything you raised or necessarily even on the base nature of the hearings, but do you or your customers very often make or take delivery on agricultural commodities?

Mr. DOHERTY. Yes, sir. I would have trouble with very often in here. We usually take and make deliveries in every delivery month in the agricultural futures in Chicago, if that fits your qualification, sir.

Mr. EVANS of Iowa. Do you have trouble putting stocks in position for delivery?

Mr. DOHERTY. We do not.

Mr. EVANS of Iowa. Do some people?

Mr. DOHERTY. Yes, sir. I would imagine at times some people would have trouble putting stocks in Chicago or in Toledo for deliverable positions.

Mr. EVANS of Iowa. Do you maintain storage space on a continuing basis regardless of whether you use it so that it will be available to you?

Mr. DOHERTY. Sir, Illinois Cooperative Futures does not have any space in its own name, sir. We do not own any concrete.

Mr. EVANS of Iowa. No, but do you lease it on a continuing basis so that it is always available to you?

Mr. DOHERTY. No, sir; we do not. We accept delivery of warehouse receipts and use it as the need arises.

Mr. EVANS of Iowa. Do you think there are an adequate number of delivery points and an adequate amount of delivery storage?

Mr. DOHERTY. I think there is. Under today's circumstances, there is an adequate amount of delivery storage. Yes, sir; I do.

Mr. EVANS of Iowa. How about points?

Mr. DOHERTY. In points, there is a very, very broad question.

Mr. EVANS of Iowa Chicago is not the great user of grains that it was once.

Mr. DOHERTY. That is true, but since that time we have also added Toledo and we have also added St. Louis and Minneapolis in the case of oats.

Mr. EVANS of Iowa. Thank you very much, Mr. Chairman.

Mr. JONES of Tennessee. Thank you, Mr. Cooper Evans, and I appreciate your dedication and loyalty to the subcommittee by being here with me all the way through. As I mentioned earlier, there are many things happening today.

Mr. Wilson, I have a question for you. Based on your strong testimony that the futures industry is one of the most underregulated industries in the Nation, I would be interested in your opinion in the role of the National Futures Association as a self-regulatory organization. I would like to know how you feel about that. Also, I would like to know your opinion of CFTC's request for authority to alter or supplement in the NFA rules.

Mr. WILSON. Could you repeat that second part? There is quite a bit of noise out from the street.

Mr. JONES of Tennessee. I would like to know your opinion of the CFTC's request for authority to alter or supplement the NFA's rules.

Mr. WILSON. The NFA, first of all, hasn't been around that long. I would say that I am certainly hopeful that they will be a good self-regulatory agency. There are a lot of very strong industry ties at the NFA. That is a concern of mine.

I think that the CFTC's powers should in no way be superceded by NFA. I think the CFTC should be able to oversee the NFA and to have a say so in the rules. That is my opinion.

Mr. JONES of Tennessee. Do you feel that NFA had done its job well as of today with its short life that it has had?

Mr. WILSON. Well, I have been trading in commodities since 1973, and I got involved in helping the public in disputes in 1977. I stopped being a broker but continued to trade. I don't believe that the NFA and the CFTC together are capable of properly enforcing and policing this industry.

You are talking about a giant industry.

Mr. JONES of Tennessee. Repeat that again, please.

Mr. WILSON. I don't think that the NFA and the CFTC together are capable of properly policing the entire industry.

Mr. JONES of Tennessee. So what is the answer?

Mr. WILSON. I would say no. To the NFA and how they have done? They are still a babe in the woods. I would rather wait another 2 years before I respond to that.

Mr. JONES of Tennessee. Thank you.

Ms. Born, are you aware of any position that the U.S. Department of State may have taken regarding the CFTC's proposal concerning subpoena powers outside the United States and, if so, would you share that with this subcommittee?

Ms. BORN. I am not aware, Mr. Chairman, of any position that the State Department has taken.

Mr. JONES of Tennessee. I would judge if you are not aware of it, no other member of the panel would be aware of anything of that sort.

This one I am going to put to the entire panel. Anybody can answer, and I hope everybody will.

The Commodity Futures Trading Commission has been in existence now for nearly 12 years. Certainly, it has been around long enough to have developed a reputation. On a scale of 1 to 10, how would you rate the Commission in terms of its effectiveness today? And I would be glad if any of you, as you rate it, will elaborate. We can start on my left and go right through, if you would like to.

Mr. WYCKOFF. Mr. Chairman, I would say that you would have to rate them on different levels of what they have done. The education and what they have done for the wheat farmer has been very well.

Mr. JONES of Tennessee. That would be what I would expect you to rate, what it has done for your industry.

Mr. WYCKOFF. I would say that they probably would be a 9 or 8 as far as what they have done for the wheat industry.

Mr. JONES of Tennessee. Mr. Wilson.

Mr. WILSON. Well, with respect to containing fraud and acting upon fraud, I would give them about a 3, and I can give you specific examples if you would like.

Mr. JONES of Tennessee. Go ahead.

Mr. WILSON. There are a number of firms, FCM's around the country, one in particular called the First Commodity Corp. of Boston. This company has been in business since 1972. It is not a member of any exchange, but it trades in futures contracts.

There are literally pages of reparations proceeding against this firm. I have just completed about a month's worth of depositions at First Commodity Corp., and the various schemes that they employ are so masterful that I am surprised, and with the number of reparations cases that have gone to the CFTC and they have almost always ruled in favor of the customer, that they haven't taken a more decisive action in shutting these people down.

First Commodity Corp. of Boston, in my opinion, from what I have seen, is a giant stealing machine. It steals fees at a rate of $30 to $40 million per year from customers and has been doing that for the past 5 years. And they have done it in different methods, lesser amounts, going back to 1972.

Mr. JONES of Tennessee. Mr. Lokensgard.

Mr. LOKENSGARD. Thank you, Mr. Chairman. I am a producer also; I am a farmer. I believe an overall number that I would come up with would be 8. I think there is reliability perceived by producers that they have been in the process of regulatory actions. We would hope that changes that are proposed would enhance that.

Mr. JONES of Tennessee. Thank you very much.

Mr. Dreyer.

Mr. DREYER. Mr. Chairman, I would have to view the question from the standpoint of what the CFTC is technically capable and willing to do as opposed to what it is practically able to do. In my practice, I would brush up against the CFTC from the standpoint of investors seeking redress.

Although they have the wherewithal and the machinery, they unfortunately don't seem to have the manpower. When a complaint is filed, reaction of the Commission is very candid—we can place you in line and you can wait 2 years until we have the capability of hearing and adjudicating your problem, or you can go to the courthouse.

The problem that the investor faces is that proceeding before the administrative judges is always, from a technical standpoint, as good or better than what he can expect to receive from a justice sitting in the district court, but it is extremely greater from the standpoint of expense to mount a litigation in the courthouse as opposed to bringing a proceeding before the CFTC.

So, from that standpoint, I would certainly have to give the CFTC low marks in being able to satisfy the needs of the investor.

Mr. JONES of Tennessee. How low, Mr. Dreyer?

Mr. DREYER. On a scale of 1 to 10?

Mr. JONES of Tennessee. Yes.

Mr. DREYER. Not greater than a 3.

Mr. JONES of Tennessee. Thank you very much.

Ms. Born.

Ms. BORN. Mr. Chairman, I have to consider the CFTC from the point of view of the foreign markets that I represent and from their impact on international markets. I think that the CFTC has come a long way toward recognizing the significance in the international commodities and futures markets of its own actions. I think they still sometimes demonstrate insensitivity to the international implications of their domestic regulation as demonstrated, for example, in their proposed bill.

So, I rate them at about a 6 or 7 on that scale, up considerably from where they were 5 and particularly 10 years ago.

Mr. JONES of Tennessee. Thank you very much.

Mr. Doherty.

Mr. DOHERTY. Mr. Chairman, I would rate the CFTC in a 7 to 8 range. I am not as aware as two of the gentlemen down here are concerned in relation to some fraud cases, if you will, or arbitration, and please believe me, I am not aware of that.

I look at CFTC from when it began and look at it today and admit to you that we ourselves and they, if you will, have differences of opinion, some of them serious in here. But I believe that this Congress as well as the discussion, the forum if you will, that we have been able to put forward in these type of hearings in here are going to be well received by the CFTC and well received by ourselves.

I think that within that form in here, things will be accomplished.

Mr. JONES of Tennessee. Thank you very much. That is a good statement. I appreciate it very much.

Little as you people at the witness table may realize, this information is worth something to us. We need it. We know CFTC is not perfect. I have been on this subcommittee since the Commission was established. We don't agree with everything the CFTC does and we don't approve of the manner in which they have handled all the cases, as has been pointed out here.

We realize that agencies and organizations in Government as well as in business have difficulties also. If you don't believe that, just get on the other side for a while and you will find it out. I have been on both sides. I do appreciate the effort that has been put forth by the present Chairman of the Commodity Futures Trading Commission and the Commissioners. They have, in my opinion, tried hard to do a worthwhile job.

That doesn't mean anything is perfect, but your testimony is worth something to us, and we really appreciate it very much.

Cooper, do you have any more questions or statements?

Mr. EVANS of Iowa. No, thank you.

Mr. JONES of Tennessee. Is there anyone else in the room who would like to say something before we adjourn this meeting? Kalo Hineman, you are a member of the CFTC. Do you want to be recognized for anything?

Mr. HINEMAN. No, thank you, Mr. Chairman. I think you had a great hearing and you conducted a very open and fair session. Thank you.

Mr. JONES of Tennessee. Mr. Davis? Is the other member here? He is not here. OK.

All right. With that, the subcommittee stands adjourned until the call of the Chair.

[Whereupon, at 3:12 p.m., the subcommittee adjourned, to reconvene subject to the call of the Chair.]

[Material submitted for inclusion in the record follows:]

STATEMENT OF
JOHN F. GILMORE,
CHAIRMAN, BOARD OF TRADE OF THE CITY OF CHICAGO

Mr. Chairman, Distinguished Members of the Committee on Agriculture.

I am John F. Gilmore, Chairman of the Chicago Board of Trade, the world's oldest and largest futures exchange. Joining me is Thomas R. Donovan, our President and Chief Executive Officer.

Although I was elected Chairman only this January, I have been an active participant in the commodity business for two decades. My first job after college was as a livestock analyst for E. F. Hutton, whose Chicago futures operations I later headed. I am now Vice President of Goldman Sachs in charge of their Chicago futures operations.

My roots in the commodity business go even deeper. My grandfather was one of the founders of Chicago's Union Stockyards. He and my father were livestock brokers. Thus, I am a commodity man through and through -- and an unabashed champion of the exchange markets that evolved in Chicago over a century ago to meet the needs of a growing nation -- markets which today are the envy of the world and are being copied in London and Tokyo, Zurich and Sydney, Singapore and Paris.

In 1985 almost 84 million contracts were traded on the Chicago Board of Trade alone -- setting a new annual trading record for the exchange and for the U.S. futures industry. This is over 4 times what we traded just 10 years ago.

Over three billion dollars in futures margin deposits are held every night in Chicago banks. A third of these deposits -- one billion dollars -- is from foreign businesses and traders.

As you can see, futures markets like the Chicago Board of Trade and the Chicago Mercantile Exchange are among the things in America that work best. The world economy depends on us more and more -- and confidence in our markets has never been greater. But the threat of over-regulation now jeopardizes this American success story.

More and more our energies are focused -- not on greater innovation and development -- but on defending our proven exchange system from regulatory assaults. All this occurs at a time when foreign exchanges, operating without the heavy hand of government regulation, are primed to take away our business.

* * *

Our first regulatory concern is the CFTC's new audit trail rule adopted this January -- some 13 months after publication of an original proposal that envisioned our brokers and traders wearing a yet-to-be-invented electronic wonder device that miraculously would time all trades as they occur.

While we strongly opposed the CFTC's fanciful scheme, I want to emphasize at the outset that we just as strongly support better audit trails. We always have and always will. Indeed, we presently have an excellent, reliable audit trail. Like any audit trail, of course, it is only an investigative tool -- not an end in itself.

And we have been and are committed to further improvements -- provided that these "improvements" do not actually destroy the efficiency of our markets. For the tens of thousands of people throughout the world who use and increasingly depend on these markets, that would be far too high a price to pay for a better regulatory record.

We demonstrated our strong commitment to improved audit trails in a number of ways:

First, by our submission to the CFTC last May detailing an innovative yet realistic alternative plan for trade reconstruction and analysis;

Second, by the several expert studies which we commissioned and made available to the CFTC, including a seminal analysis by Dr. Merton Miller of the University of Chicago and Dr. Sanford Grossman of Princeton University;

Third, by our briefings and demonstrations to the CFTC last year of our computerized trade reconstruction and surveillance capabilities; and,

Fourth, by our continuing offer to establish a dialogue with the CFTC on this important matter, particularly with regard to the details of our alternative plan.

Months passed, but whatever the Commission was up to was veiled in a web of secrecy. It seemed that our proposition had fallen into a bureaucratic black hole. Abruptly, on January 10, we were presented with the Commission's new rule in final form. Read literally, it seemed to mandate one minute trade timing with 100 percent accuracy 100 percent of the time.

As one CFTC Commissioner as well as CFTC staff readily acknowledged, however, no exchange could satisfy the literal mandate. The literal standard was and is impossible to meet in fast paced open outcry markets where split-second simultaneous executions are commonplace.

We did not throw up our hands or rush to litigate, however. Instead -- and further underscoring our commitment -- the Chicago Board of Trade and the Chicago Mercantile Exchange joined together and went back to the drawing board. We hoped that we could perfect a system that would meet the CFTC's new mandate to the greatest extent possible, without sacrificing market efficiency.

And together we succeeded. The new System which we detailed to CFTC Chairman Phillips in Chicago on February 11 and to CFTC staff in Washington on February 12 and 13 relies on trade information universally accepted as reliable and utilizes sophisticated and proven mathematical computations as well as state-of-the-art computer technology.

Called "CTR" (for Computerized Trade Reconstruction), the System produces not only an extremely accurate and comprehensive audit trail -- including the time of most trade executions to less than the nearest minute -- but also a remarkable surveillance tool for rapid on-line analysis of trade data from our fast moving auction markets.

For example, the CTR System will provide the very next day a complete profile of any of our markets -- who traded, when, with whom, at what price, in what amount -- sorted by trader, by price, by time, by amount, by whatever is relevant.

In our view, it is the finest trade surveillance system yet devised. Most importantly, although our brokerage firms definitely will incur cost increases, the CTR System should not impair market liquidity. In addition, it complies fully with any reasonable reading of the CFTC's new rule.

We are pleased to report that on February 27, in response to our offer to present an in-depth briefing on the CTR System, CFTC Commissioners Davis and Hineman, followed by Commissioners Seale and West, met with us at two comprehensive sessions in Washington. They were joined by a number of senior CFTC staff personnel.

In view of the importance of this matter and to underscore our strong personal commitment to achieving a resolution of the entire audit trail issue as quickly as possible, President Donovan and I and Leo Melamed and William Brodsky of the Chicago Mercantile Exchange traveled to Washington and participated personally in the briefings.

At the briefings we detailed each of the elements of the CTR System and its underlying methodology. Technical experts discussed the sophisticated computer applications to be employed. Trade data from one of our mainframe computers in Chicago was on-line and displayed, to demonstrate the surveillance as well as audit trail benefits of CTR. Descriptive materials were distributed, and we responded to a number of useful questions.

Better than any report or staff summary, we believe that these briefings facilitated the Commissioners' evaluation of the new System -- both in terms of its compliance with the new CFTC rule and, just as importantly, its impressive surveillance capabilities.

We recognize, of course, that we are advancing a revolutionary new application of statistical theory and computer logic. There obviously are aspects of the System that cannot be measured conclusively (or even tentatively) until the System is in place and fully operational. For example, only the CTR System can perform the complex data analysis necessary to determine certain trade execution times. This cannot be duplicated manually, notwithstanding the great expertise of our trained surveillance staffs. Only a computer is capable of doing the job.

We believe that these briefings did demonstrate conclusively to the CFTC that we have moved far beyond the conceptual stage. We are advancing a most precise system in concrete and specific terms which will enhance dramatically our audit trail and surveillance capabilities. And we will accomplish this without any adverse impact on those who rely on our markets for risk-shifting and price discovery.

After all, protecting the market mechanism must come first. That's why we exist, and why the world comes to us.

We are sincere in our commitment to having the best audit trail and trade surveillance system possible. We are proud of our new CTR System, which will achieve this goal. We are dedicated to making every reasonable effort to work with the CFTC to make this a reality as soon as possible.

Notwithstanding the record on this vexing issue, we believe that the CFTC now recognizes the obvious merits of our computerized System, and its superiority over the pencil-and-paper system that some have advanced and the CFTC's new rule at first blush appears to embrace.

Nonetheless, since so much is at stake to our markets, we must continue to ask Congress to revoke the CFTC's new rule, unless the CFTC can give us the green light to proceed by confirming unequivocally that CTR indeed does comply with their new rule.

We believe it does. But before we invest thousands of additional hours and hundreds of thousands of additional dollars, we must have some firm assurance that six months from now -- or two years from now, or whenever it may seem convenient or expedient -- the CFTC does not declare that it really meant pencil-and-paper all along.

The best we have gotten thus far are vague statements that CTR has the "possibility" or "capability" of compliance -- whatever that means. This is thin gruel indeed when compared with what we are expected to undertake at great cost -- and great risk should the CFTC simply change its collegial mind.

* * *

Audit trails is only one example of the burdensome and often incoherent and haphazard rulemaking style that prevails at the CFTC. Another example is the CFTC's rush last fall to adopt far-reaching changes in CFTC financial requirements for FCMs. These changes were proposed without any concrete analysis of their potential impact. As a result, thousands of industry hours -- in the case of the Chicago Board of Trade and our member firms alone, over 3,700 hours -- were spent in analyzing untested CFTC proposals. In many instances we later learned, we had been forced to analyze specific provisions that the CFTC staff already had abandoned.

Thus, meaningful comment was made impossible. And to make matters even worse, the time afforded for comment was far too brief. Fortunately, the CFTC was forced by an unprecedented deluge of public protests to extend the comment period. It now ends early next month.

Each of these protest letters in the CFTC's public file stands as an indictment -- not only of the CFTC's financial proposals, but of its rulemaking practices in general. And regarding the financial proposals specifically, there is no guarantee that ultimately the CFTC will not adopt these destructive requirements.

If the CFTC's rules are adopted as proposed, at least 38 percent of our member firms will be forced to put up additional capital or shut their doors -- for no reason at all. The

Chicago Board of Trade -- and several other major exchanges -- have not experienced the loss of a single customer dollar since the clearing house system began over half a century ago.

Industry-wide, futures customer losses from 1938 to 1984 -- a 46 year period -- did not exceed 10 million dollars. By contrast, SIPC, the security industry's customer insurance corporation, paid out over 15 times that amount in half the time -- 153 million dollars from 1971 to 1984.

As one commentator -- Cargill Investor Services -- observed, the CFTC's proposed approach is like "attempting to solve a problem with a nuclear warhead where a fly swatter would suffice."

When you consider that the average rate of return on capital for our member FCMs who are not also securities brokers is only about 5.8 percent -- or less than the rate of return from investing in government securities -- it is not far-fetched to envision a mass exodus of firms from our industry, if the CFTC proposals are adopted as proposed. And these will be the firms that specialize in serving the thousands of coops, country elevators, and agricultural producers who depend on our markets.

* * *

Particularly disturbing in connection with both of these episodes is the CFTC's failure to conduct any cost-benefit analysis. This comes from an agency headed by a professional economist who wrote only five years ago that regulatory programs "should be judged in terms of their costs and benefits."

In our view the need is clear. Something must be done about CFTC rulemaking authority generally, to promote greater responsibility and accountability, to help prevent excessive and misguided regulation, and at least to assure that some advance analysis is done before the private sector is asked to spend countless thousands of dollars and hours responding to proposals. Thus, we urge that the Commodity Exchange Act be amended --

First, to mandate that the CFTC conduct and issue a regulatory impact analysis of proposed rules, including an assessment of both the benefits and the costs;

Second, to provide a mechanism for regular congressional review of CFTC rules; and

Third, to modernize the standards and procedures for judicial review of CFTC rules.

The reforms we urge are not novel. Indeed, they have been recognized by regulators, the Courts, and Congress as important tools for improving the regulatory process.

Nor do we advance these reforms as some newcomer to Federal regulation -- smarting under a regulatory yoke for the very first time. As this Committee knows, Federal commodities regulation has been in place since 1922 -- thus predating Federal securities regulation by over a decade. By any rational standard, the Federal rulebook already has been written. In fact, we now have the 64th edition.

And as one of America's oldest self-regulatory bodies, founded in 1848 for that very purpose, we do appreciate the need for regulation -- provided it is reasonable and responsible. On this point, it is a credit to the wise policies of this Committee that America's commodity exchanges, notwithstanding 64 years of Federal oversight, continue to be viewed throughout the world as exemplars of our great free enterprise system.

* * *

Rather than seeking greater accountability and responsibility for its regulatory programs, the CFTC is taking a diametrically opposite approach. Congress is asked to insulate the CFTC even further by barring Federal District Court review and independent fact finding regarding CFTC actions, and by mandating that the limited Court of Appeals review which would be allowed must be conducted on the CFTC's made-to-order record. We strongly oppose this measure.

The CFTC's request for virtual carte blanche authority to rewrite the rules of NFA also is unwarranted. Despite the proven record of NFA, the CFTC says it needs plenary authority to rewrite NFA's rules -- and notwithstanding that NFA is a private corporation which relies on not one single cent of tax dollars. The industry has supported NFA to the amount of $46 million since its inception.

The CFTC's rationale for this power grab is the fact that it already has broad authority to rewrite exchange rules. We submit that that power should be checked -- limit CFTC authority over exchange rules; don't increase its power over NFA rules.

In yet another CFTC attempt to obscure its accountability and responsibility, the CFTC has requested an unprecedented six-year reauthorization. Given the CFTC's recent record, we suggest a two-year reauthorization, with a firm commitment to regular interim oversight hearings by this Committee.

* * *

There is one issue where we generally agree with the CFTC -- leverage. The CFTC has proposed that Section 19 of the Commodity Exchange Act be repealed. The result of this would be to require that leverage contracts -- like all other futures contracts -- be traded on regulated exchanges by competitive open outcry.

More specific, direct, and preferable leverage legislation has been introduced by Congressman Glickman, cosponsored by Congressmen Daschle, Gunderson, and L. Evans. H.R. 3434 would expressly recognize leverage contracts to be futures contracts and, thus, require leverage firms to comply with all statutory provisions for futures contracts. Leverage trading has caused millions of dollars of customer losses and constitutes a serious threat to the legitimate futures industry which must be stopped now.

One of the requirements for legitimate futures contracts is that new contracts must be designated by the CFTC. Unfortunately, the Commission continues to drag its feet in processing designation applications. In response to Congress' efforts in 1982 to speed up and modernize this process, the CFTC designed a marvelous new device for delay -- the infamous "materially incomplete" letter.

By a mere letter from any staff member, the Congressional intent to expedite new product approval is overruled. In the meantime, exchanges regulated by the SEC are able to offer new products on a speedy basis. We urge, therefore, that further steps be taken to assure that our markets have equal access to new products, by providing for automatic designation of contracts after a reasonable review period.

Another bar to market access is the Commission's hedge definition. Written over a decade ago, the definition is seriously outmoded. We request that Congress direct the CFTC to review, reconsider, and modernize that definition and specifically to deal with a number of vital new products such as agricultural options.

* * *

Of paramount interest to us and this Committee is how to improve our markets for the benefit of American agriculture. We have two specific suggestions. The first concerns agricultural options.

Four years ago Congress wisely lifted the ban on agricultural options and authorized a pilot program on the nation's commodity exchanges. Unfortunately, several years passed before the CFTC put in place its implementing regulations, and trading did not begin until the fall of 1984 -- and then on a very limited basis. Also unfortunately, the CFTC has continued to limit severely the number of options that can be traded on any one exchange. The Chicago Board of Trade, for example, has not been able to offer a wheat option.

We have been limited to two options -- soybeans and corn. In 1985 over 840,000 soybean options and over 363,000 corn options were traded on the Chicago Board of Trade. Average daily volume was 3,390 contracts for soybeans and 1,747 contracts for corn.

These are respectable numbers, indicative of viable established markets. Obviously, we wish they were higher, and we will continue in our efforts to make this important new risk-management tool better understood by the U.S. farmer. Already we have conducted 287 programs, distributed almost 900,000 pieces of literature, and spent approximately $3 million in this educational effort.

What is needed now is to lift statutorily the artificial restrictions that the CFTC has imposed, to permit the Chicago Board of Trade and other exchanges to offer options on all agricultural and other commodities on a permanent basis.

Our second recommendation concerns speculative limits. For 50 years the Commodity Exchange Act has authorized the setting of limits on the number of contracts a speculator may hold or control. Using corn as an example, only once in these 50 years have limits been increased -- 15 years ago, in 1971, from 400 contracts to 600 contracts. These markets now reflect world participation and production; the current limits do not. We strongly believe that increasing limits will make our markets more efficient, particularly in the deferred months where hedging has become very difficult if not impossible.

Our suggestion is that Congress direct the CFTC, within six months, to prepare proposed rules for increasing agricultural speculative limits and to submit these rules to Congress for its review, while also soliciting public comment.

* * *

Summarizing briefly our recommendations, the Chicago Board of Trade urges:

(1) Revocation of the CFTC's new audit trail rule, unless the CFTC unequivocally confirms that the joint Chicago Board of Trade-Chicago Mercantile Exchange computerized trade reconstruction and surveillance System complies with the rule and thus can be placed in operation as soon as possible;

(2) A congressional declaration that leverage contracts are futures and must be traded like all other futures;

(3) Reform of the CFTC rule-making process;

(4) Direction to the CFTC to increase agricultural speculative limits;

(5) Expansion of and permanent status for the options pilot program, including agricultural options;

(6) Direction to the CFTC to modernize its hedge definition;

(7) A system for expedited contract market designation approval;

(8) Rejection of the CFTC's request for carte blanche authority to rewrite the NFA Rulebook;

(9) Rejection of the CFTC's request to insulate itself even further from accountability and responsibility by limiting review of its actions to the Courts of Appeals; and,

(10) A two year CFTC reauthorization.

* * *

In conclusion, Mr. Chairman, the Chicago Board of Trade is very grateful for having had this opportunity to present its views. They are strong, I know. But a great deal is at stake.

I know from personal and most painful experience what excessive, misguided, or outmoded regulation can mean, no matter how well intentioned it may be. As I mentioned at the outset, my grandfather, Allison Gilmore, helped found Chicago's Union Stockyards. As a young man, alongside my father, I witnessed the slow death of that once great institution. In its last years, there were more regulators on the scene each day than there were people to regulate.

No more, of course. Not a single regulator remains -- or anyone else. The great Chicago Stockyards is now warehouses and parking lots.

Yes, Mr. Chairman, a great deal is at stake.

Thank you.

STATEMENT OF WARREN W. LEBECK, REPRESENTING THE NATIONAL GRAIN TRADE COUNCIL

Mr. Chairman, members of the Committee, my name is Warren Lebeck. I appear before you today representing the National Grain Trade Council. I am a member of the Council's Board of Directors and Executive Committee.

The Council is a national trade association whose policy making members include grain exchanges, boards of trade and national grain marketing associations. Of particular note is the fact that those who represent these organizations on the Council are all users of the agricultural futures markets. As users of the markets they are vitally interested in how the markets function and how they are regulated. Consequently, the Council appreciates this opportunity to appear before the Committee to present its views on the CFTC.

For the most part the comments we wish to make will already have been elaborated on and our short statements only wish to reinforce what has already been said.

We support reauthorization and feel that the term should be for at least six years. The four year term is too short and requires too much time and effort on the part of Congress, the CFTC, and the industry.

We favor the recommendation that the contract approval process be shortened from one year to six months. Unfortunately, even with that change the CFTC has too many opportunities to delay approval of contracts that could be of great benefit.

User fees are not necessary and could harm self-regulation. The CFTC has given the NFA high marks for its performance and users already pay the fees that support that organization.

The Council feels that margins have been handled satisfactorily by the exchanges and there is no need to change the present system. They have provided a safe balance between protection and use.

Agricultural options have proven their usefulness. Of special note is the fact that producer groups support them. There is no longer a need for a pilot program. Agricultural options should be opened up.

With regard to leverage contracts, they should only be traded on licensed exchanges on the same footing as futures contracts.

One of the serious problems for users of agricultural futures is the lack of trading in the deferred contracts primarily as a result of recent tax changes. Commercial users of the markets have been harmed by this lack of liquidity, which also reflects itself unfavorably in prices to producers, and recommend that the tax situation should be looked at. In addition, raising of speculative limits could have a positive effect, principally through encouraging funds to take a more active part in the deferred contracts.

The Council supports the CFTC's legislative proposal to eliminate the automatic stay of NFA disciplinary actions through an appeal to the CFTC. The Council, however, does oppose the CFTC recommendation for more power over NFA's rules. By their own admission NFA has worked well to date. Thus, additional authority is neither needed nor justified.

The next two items, the proposed CFTC capital rule and the audit trail proposal deserve much more discussion.

For Council members as users of futures markets, the economic viability and utility of the markets is of the utmost importance. There is a natural concern about the capitalization of exchange member firms. Yet experience in the agricultural markets has been exemplary. The manner in which the agricultural futures markets handled the volatile 1973 markets when grain prices reached all-time highs and the manner in which these same markets handled a financial problem occurring at practically the same time as the Volume Investors situation, leads the Council and its members to have great confidence in the experience and professionalism of these markets and their ability to handle financial difficulties.

The CFTC proposals would appear to further concentrate the business in fewer and fewer hands, which could only lead to greater risk should there be a problem.

It is clear that had present rules and procedures been followed in the Volume Investors situation, the problem might not have occurred or at least would have been greatly minimized.

Quite frankly, it appears clear that the CFTC has reacted with an ax when a scapel in the hands of those skilled in these matters would have sufficed. What is needed is a properly constructed capital rule carefully drawn with inputs from those who have successfully weathered financial storms.

Members of the Council are also, of course, concerned that their orders be handled correctly on the floors of the exchanges. BUT, they are more concerned that their orders be handled expeditiously. In active markets a delay of even a few seconds can mean missing the market or getting,a much less satisfactory fill.

The Commission and its staff seem to have ignored the economic impact that their proposal will have and have most certainly ignored studies submitted by the Chicago Board of Trade while having made no comprehensive studies themselves. The refusal of the Commission to understand the consequences of its proposal and its effect on the public interest or even to listen, is disturbing to those who use the market and will be affected by such shortsightedness.

This leaves Council members and other users of the market faced with a dilemma -- which is the greater threat -- the possibility that an order will be mishandled or the reality that one minute time recording will delay executions? After reviewing the audit trail proposals submitted by the Chicago Board of Trade and the Chicago Mercantile Exchange, the Council and its members are convinced that these give adequate protection against possible abuse without having to disrupt market activity.

One also wonders if the CFTC has considered the fact that its proposal seems to give any broker an automatic excuse for unsatisfactory fills -- "Sorry, I was time recording executed trades when the market moved."

One final comment. When reviewing the performance of the CFTC I am reminded of a definition of an economist that I have heard -- an economist is one who observes something that works and then spends time wondering if it will work in theory.

Any comments about the CFTC in this testimony are intended to be constructive. There is no need to merge the CFTC with any other agency. What is needed is more appreciation of what the markets do and more appreciation for the experience of those who have kept their markets functioning successfully lo these many years. A little more responsiveness to the industry as a whole is all that is needed.

Again, our thanks for the privilege of presenting our views.

STATEMENT

OF

PHILIP A. FEIGIN
ASSISTANT SECURITIES COMMISSIONER
COLORADO DIVISION OF SECURITIES
AND
CHAIRMAN, COMMODITIES COMMITTEE
NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

Mr. Chairman and Members of the Subcommittee:

I thank you for affording me the opportunity to appear before you today to testify regarding the Commodity Futures Trading Commission (CFTC). I submit this statement in my capacity as both Assistant Securities Commissioner for the Colorado Division of Securities and as Chairman of the Commodities Committee of the North American Securities Administrators Association, Inc. (NASAA), a voluntary association of securities administrators from all fifty states, the District of Columbia, the Canadian provinces, Puerto Rico and Mexico.

I would like to begin my remarks today by commenting in general terms on the present relationship between the CFTC and the states. In a word, it is excellent. The jurisdictional disputes and vitriolic language that characterized state testimony in oversight and reauthorization hearings in the past have faded into history. Utilizing sections 6d and 12(e) of the Commodity Exchange Act, the CFTC, the National Futures Association (NFA) and the states have joined forces in a concentrated attack on off-exchange commodities-theme fraud.

This new era of cooperation is evidenced by joint investigations and enforcement actions, CFTC and NFA enforcement training seminars for state enforcement personnel, the providing of expert witnesses and analysts, and perhaps most notably, the drafting of the Model State Commodity Code. Taking advantage of section 12(e) of the Commodity Exchange Act (the so-called "open-season" provision), the Model Code fills the gap between the Commodity Exchange Act and traditional "blue sky" laws (state securities laws). It provides states with a clear jurisdictional basis to act against these scams, and provides effective, swift and comprehensive enforcement tools to use against those who would violate its provisions. As of this writing, the States of Missouri, New Mexico and Washington have enacted the Code, legislation to enact it in one form or another is pending in Minnesota, Maine and Arizona, and several other jurisdictions are considering its introduction in upcoming legislative sessions. The CFTC, NFA and the states believe that the Model State Commodity Code will prove to be a very effective state weapon in the ongoing battle against boiler room fraud.

NASAA strongly supports the CFTC. The Commission has done an admirable job with its all too scarce resources in regulating the contract markets in the midst of an explosion of new products and problems. Though I believe the CFTC has done its best in the off-exchange area, it is still regrettable, if not shocking, that a suspected one hundred or more boiler rooms purveying illegal futures contracts operate with near impunity in Southern California. While it is true that no amount of money or staffing will ever eliminate all fraud, the continued existence of these firms is an affront to justice. They advertise nationally, they have listed telephone numbers, they may even belong to Chambers of Commerce, and they have been in business for months if not years. They are known and identified, and yet little if anything can be done about them due to lack of resources. NASAA urges the Congress to enhance the CFTC budget so that these criminals, sapping billions from the economy each year, are finally attacked on a broad front and stopped.

Allow me to turn now to the specific proposals as contained in the CFTC's reauthorization bill currently under consideration in the Senate. Three of the proposals fall into the general category of the enhancement of the Commission's enforcement powers, to wit: the addition of extraterritorial service of subpoena authority, the authority to seek the appointment of a temporary receiver on an ex parte basis, and the clarification of the section 4b anti-fraud provision. NASAA supports each of these proposals. The internationalization of the commodities markets has made extraterritorial service a necessity. The ex parte relief provided in section 6c of the Commodity Exchange Act has proven to be a very effective device but the true guarantee of efficacy is missing -- a temporary receiver. The addition of such authority would not really expand enforcement authority; it would merely assure the effectiveness of the authority and relief already provided.

The final proposal concerning section 4b is practical and important. However, it may be too limited. If the problem of ambiguity described by the Commission exists with regard to section 4b, it may also exist with regard to section 12(e), a provision most important to the states. It is generally accepted that section 12(e) provides that a state may apply any law available to transactions effected off-exchange except those transactions effected in compliance with section 4c or section 19(c), the options and leverage provisions, respectively. It is clearly the intent of section 12(e) to afford the states the opportunity to pursue, for instance, illegal options contracts such as London options. However, with the "subject to" language of 12(e), an argument can be made that options sold in violation of 4c are nonetheless "subject to" regulation under the section, and thus, the states are preempted from enforcing their laws against them. Therefore, NASAA supports the proposed change to section 4b but also urges that equivalent changes be made in section 12(e).

Although NASAA has little interplay with the Commission as to the proposals involving appellate review, NFA rules and procedures, and section 9(d), we find the proposals acceptable and support their adoption. We also believe that a six year reauthorization cycle is appropriate for the Commission.

To the NASAA membership, the most important issue presently being discussed is the proposed elimination of leverage contracts from separate recognition and treatment under the Commodity Exchange Act. NASAA is already on record as supporting this concept. We have voiced our support for a such a proposal made by Representative Dan Glickman, of this Subcommittee, in H.R. 3434.

The arguments for and against leverage have been stated repeatedly over the years. We find the arguments that leverage contracts are not in fact futures contracts to be wholly unconvincing. The alleged and contrived distinctions between futures and leverage contracts are as transparent as the Emperor's new clothes. The Commission staff has repeatedly failed to find any economic justification for the contracts.

The concept of the leverage contract is problematic in itself. The phrase "off-exchange futures contract" should be an oxymoron. The open outcry and free price discovery of the exchange is missing in leverage. The impartial and neutral guarantees, stability and oversight afforded by exchanges and clearinghouses in the futures markets are absent in leverage. Futures customers can transfer their accounts from brokerage to brokerage, but a leverage customer is wed irrevocably to his leverage company. While many consumers shy away from the formal commodities markets based on the common knowledge recognition of volatility and risk, they may be lured to leverage investments by vague allusions to ownership of gold or other precious metals and hedges against inflation for the future.

The Commission is already on record holding that leverage contracts are in fact futures contracts. Therefore, if leverage contracts were to be traded under the proposed amendment to the Commodity Exchange Act, an exchange would have to request of the Commission permission to offer them. Such permission would only be granted on a showing of economic purpose and viability and the CFTC staff has already held to the contrary. The practical effect of the proposed amendment would be the elimination of leverage from the commodities industry. The net result would be that the two existent companies would be either put out of business or made to fundamentally alter their methods of doing business, a hard course for the Congress to take.

What are the alternatives? It is our position that they are much worse, and that they are contrary to the public interest. Leverage contracts should never have been allowed 12 years ago. If the two companies are allowed to continue the development of off-exchange futures trading, it is almost certain that their monopoly in the business created by the moratorium on the entry of new firms into the market will not last long. It is anti-competitive and contrary to American economic policy. Soon, there would be more and more firms entering the leverage market.

Pressures to trade more and more products would grow. Perhaps we would see a day when trading in off-exchange futures contracts in wheat, corn, cotton, coffee and frozen orange juice concentrate might be commonplace, with many firms participating.

The CFTC lacks the manpower to adequately address even the problems posed by the existing two firms, let alone an influx of more companies -- and it is hard to believe that expansion would not be inevitable. In securities regulation, while there is an important and thriving off-exchange securities market, there are also fifty state blue sky agencies backing up the Securities and Exchange Commission, the exchanges and the National Association of Securities Dealers. There is no such concurrent state jurisdiction to patrol, police and regulate a legalized off-exchange futures market. The results would be catastrophic.

Congress is faced with a "Hobson's choice." To eliminate leverage would likely mean putting two firms out of business. To perpetuate leverage would mean the confirmed sale of inherently unfair off-exchange futures contracts by the two firms and would likely lead to growth in the number of off-exchange futures trading firms and products without the essential safeguards. The public interest on consumer protection and in the trust and confidence of the public in the commodities marketplace demand that Congress put an end to this right now. To attempt to stretch and pervert the fundamental concept of the commodities system -- the exchange trading of futures contracts -- to suit two special interests is like trying to move the river closer to the town.

Let us suppose for a moment that leverage contracts never developed, and today a brokerage firm were to come before the Congress and propose an amendment to the Commodity Exchange Act allowing the creation of a radically new instrument -- an off-exchange, long term futures contract wherein the brokerage firm would take one side of the contract and the customer the other. We believe it's certain that the proposal would be summarily rejected.

There is no reason or justification for leverage contracts. In some respects, they are inherently unfair to the consumer. If there is true consumer demand for such products, they should be and will be developed at the exchange level. Off-exchange futures trading cannot be allowed to continue and should be made uniformly illegal. NASAA wholeheartedly endorses and supports the CFTC's proposal with regard to leverage.

I thank you for your kind attention and will be glad to answer any questions I can.

Statement of

John D. Brookmeyer, Jr.

on behalf of

The Prudential Insurance Company of America,
Metropolitan Life Insurance Company, and
The Equitable Life Assurance Society of the
United States

Mr. Chairman and Members of the Committee, I am John D. Brookmeyer, Jr., Vice President of The Prudential Insurance Company of America. In this capacity, I am in charge of publicly traded fixed-income investments for The Prudential. I am appearing this morning on behalf of The Prudential Insurance Company, Metropolitan Life Insurance Company, and The Equitable Life Assurance Society of the United States. As three of the country's largest life insurance companies, we have been in the investment management business for many years. In addition to managing our own general corporate assets, we provide investment management to pension plans, mutual funds, foundations, endowments, separate accounts that fund life insurance and annuity products, and others. Our combined assets total over $225 billion, and we provide investment management and advice, either directly or through our subsidiaries, to portfolios whose total value is in excess of $180 billion.

As investment managers, we are already regulated in several capacities, including, most importantly, as registered investment advisers under the Investment Advisers Act of 1940, and also as ERISA fiduciaries in our management of pension plan assets. Within the last few years, institutional investment managers such as insurance companies have begun to utilize financial futures contracts and related options as aids in the management of their clients' securities portfolios. This has led to a potential for duplicative, unnecessary and ill-suited regulation under the Commodity Exchange Act, which is the topic that I would like to address today.

In the Futures Trading Act of 1982, Congress clarified many important issues regarding the respective jurisdictions of the CFTC and the SEC in light of the advent of financial futures contracts. But two important and related issues were not expressly resolved by that legislation -- namely, that managers of securities portfolios who are already subject to appropriate regulation by the SEC might become subject to unnecessary and ill-suited regulation as, first, commodity pool operators ("CPOs") or as, second, commodity trading advisors ("CTAs"), simply because they employ financial futures in connection with the management of securities portfolios. One of these issues -- the CPO issue -- was addressed last year by the CFTC through its adoption of Rule 4.5, which excludes certain otherwise regulated entities from the definition of a CPO when they use futures in limited ways. This rule -- which was prompted by a statement in the Senate Agriculture Committee's Report on the Futures Trading Act of 1982 that such exemptions would be appropriate -- has been quite helpful, although there is a need to broaden certain of its provisions.1/ But the second and closely related issue of whether otherwise regulated entities that provide securities advice and management should be subject to regulation as CTAs if they use financial futures as a tool in the management of securities portfolios has not been addressed by the Commission. And the issue has become a critical one for insurance companies and other institutional investment managers. It is our view that subjecting such already-regulated advisors to further registration and regulation as CTAs (1) serves no valid purpose, (2) imposes inappropriate burdens on such advisors, and (3) puts such advisors at an unjustifiable competitive disadvantage as compared to banks and trust companies, which are expressly excluded from the Commodity Exchange Act's definition of a CTA.

1/ This includes, for instance, the need identified in the testimony of Mr. Seevers of Goldman, Sachs & Co. to formulate an updated definition of hedging that recognizes the concept of prudent risk management by institutional investment managers.

I. The Use of Financial Futures by Managers of Securities Portfolios

Financial futures and related options are extremely useful tools that help professional money managers -- insurance companies, investment advisers, banks, trust companies, etc. -- deal with the risks of today's volatile and unpredictable capital markets. Use of futures can provide significant advantages in the management of a securities portfolio. It must be borne in mind, however, that such advisors are engaged in managing securities portfolios, and hence their primary business as registered investment advisers involves investments in securities, not futures. As a result, first, such advisors are already fully regulated in such activities by the SEC as registered investment advisers. And, second, financial futures are used by such advisors not for speculative trading, but only as a useful and important tool in the modern management of securities portfolios.

Before discussing some of the important uses of financial futures in the management of securities portfolios, it is important to first note some salient characteristics of the financial futures markets that enable futures contracts to be such effective management tools. The futures markets, in U.S. Treasury securities in particular, are large and liquid. Indeed, on some days a greater market value of Treasury Bond futures contracts is traded on the Chicago Board of Trade than there are actual U.S. Treasury securities traded in the Treasury market itself. This liquidity means that futures transactions can often be accomplished much more quickly than transactions in the securities markets and with less market impact and, consequently, with lower transaction costs. In addition, commission costs are lower for futures transactions than are commission costs or dealer spreads for stock or bond transactions. These qualities make futures extremely useful in implementing strategies in a securities portfolio -- particularly if timing is important.

Large investment programs of institutional investors take time to implement. The portfolio manager must select appropriate securities to purchase or sell and must effect these purchases or sales gradually so that the transactions do not have an unfavorable impact on the securities' market prices. As a result, efficient execution of a large investment program often takes days, weeks or even months to complete. During this time the market can move as a result of changes in interest rates or stock prices before the investment program is completed. The portfolio manager who is able to use futures can hedge against such adverse market movements by buying or selling financial futures contracts -- because of market liquidity the futures transaction can be effected swiftly -- and, thus, permit the portfolio manager the time needed to complete the planned investment program in an orderly manner.

Thus, the manager of a bond fund may be concerned about a possible decline in interest rates and the resulting increase in market price of debt securities that the manager intends to acquire in an orderly way. That manager may accordingly purchase an interest rate futures contract to hedge against that anticipated increase in the price of the debt securities it intends to purchase. On the other hand, a portfolio manager who fears a temporary market decline may sell futures to offset an anticipated decline in the value of portfolio securities; the short futures position would be terminated when the portfolio manager is no longer concerned about market weakness. This hedging strategy may be a sensible alternative to the sale of portfolio securities and possible reinvestment later. Indeed, it often makes no sense to sell a substantial portion of a well-designed securities portfolio as a means of temporarily reducing market risk and later restoring that portfolio at a significant cost.

In addition, because the sale or purchase of interest rate futures may be used to produce the economic equivalent of increasing or reducing a portfolio's holdings of either short term investments or long term bonds, and because these transactions can be accomplished more quickly and cheaply than the equivalent securities transactions, futures can be used to adjust the duration of a fixed-income portfolio in response to changing interest rates or changing liabilities. Stock index futures contracts and options on futures contracts can be used in equally useful and non-speculative ways in the management of portfolios of securities.

The usefulness of futures and related options is now widely acknowledged by institutional investment managers. Indeed, many of the sophisticated clients of such managers -- such as pension funds -- have become aware of the benefits that use of the futures market can bring to the management of their portfolios and are increasingly requesting that their investment managers use these instruments. It is not uncommon for pension funds who are seeking a new investment manager to ask about the manager's ability to use futures and options on futures in managing their portfolios. Moreover, in order to design competitive new investment products, such as mutual funds, it makes good business sense to incorporate appropriate uses of futures and options on futures. However, at present, apart from the limited and inadequate 15-person exemption, institutional investment advisors such as insurance companies can use futures and options on futures in advisory accounts only upon registration and regulation under the Commodity Exchange Act. Thus, unless the regulatory framework is changed, investment advisors such as ourselves will be constrained from designing such products and from using these instruments in the management of our client portfolios in accordance with our best investment judgment. Certain of our clients may seek an advisor, such as a bank or trust company, which is not subject to such constraints.

It is essential that prompt action be taken to provide appropriate exemptions or regulatory relief so that institutional investment managers can continue to be able to use the best available investment tools for the benefit of their clients without becoming subject to regulations which, as we now show, are burdensome, inappropriate and, where appropriate, already provided for on the federal level.

II. Regulation of Insurance Companies and Other Institutional Investment Managers As CTAs Is Unnecessary and Inappropriate

The 1974 Amendments to the Commodity Exchange Act that created the CFTC also established the regulatory framework for commodity market professionals such as FCMs, CPOs, and CTAs. Registration and recordkeeping requirements and antifraud standards analogous to those in the federal securities laws were created. With respect to CTAs, "the legislative history indicates that the purpose of the 1974 amendments applicable to advisers was to discourage the enticement of unsuspecting traders, and to eliminate undesirable business practices." CFTC v. Savage, 611 F.2d 270, 285 (9th Cir. 1979).

But investment advisers registered with the SEC under the Investment Advisers Act of 1940 are already subject to regulation and supervision that provide the necessary protection. First, the Investment Advisers Act and the Commodity Exchange Act contain identical anti-fraud provisions. See 15 U.S.C. § 80b-6 and 7 U.S.C. § 60. Second, information concerning certain management personnel involved in developing or providing investment advice, including educational, business, and disciplinary histories, must be provided to the SEC on Form ADV. The SEC must also be provided with detailed information concerning the nature of the adviser's business, including generally the adviser's most recent balance sheet and descriptions of the fee arrangments, the types of advisory service provided, the adviser's sources of information and methods of analysis, and the investment strategies generally employed including whether futures and related options may be used. Form ADV, Part II. These registration requirements are substantially the same as those required of CTAs by the CFTC and the National Futures Association ("NFA") under Forms 7-R and 8-R.

Next, the Investment Advisers Act requires advisers to make detailed disclosures to their clients, including at least the information contained in Part II of Form ADV, which details such items as fee arrangements, the basis of the adviser's techniques, and the use of futures. SEC Rule 204-3. Prospective investors in mutual funds advised by institutional advisers must be furnished with prospectuses which must contain a description of the fund's investment objectives and policies, the types of securities that will be purchased, and any special risk factors associated with the fund. 15 U.S.C. § 77e. And with respect to pension plans advised by institutional advisers, ERISA establishes a system of fiduciary obligations that provides ample protections against the practices sought to be controlled by CTA registration and regulation. In each of these situations, then, there exist regulatory requirements that substantially duplicate all the appropriate information contained in the "Disclosure Document" that a CTA must furnish to its customers. 17 C.F.R. § 4.31(a).

Registered investment advisers are also subject to appropriate requirements regarding recordkeeping, custody of clients' funds, and supervision of personnel, as well as to proscriptions on misleading advertising and fraudulent practices. Accordingly, an investment adviser registered as such with the SEC is already subject to the full panoply of appropriate federal regulation and supervision over all of its advisory activities regarding securities portfolios, including portfolios that may use financial futures or options. Thus, in sum, registration and regulation as a CTA is unnecessary and would be largely duplicative.

The problem is more than one of unnecessary and duplicative regulation, however. CTA regulation also imposes further duties that, because they were developed in connection with traditional CTAs in mind, are inappropriate and unwarranted as applied to institutional advisers who use futures in connection with the management of securities portfolios. First, under the rules of the CFTC and NFA, a CTA's principals (including, for example, the insurance company's board of directors) and associated persons must be fingerprinted so their true identity can be ascertained and background checks conducted. But the identity and business backgrounds of an investment adviser's directors and personnel are already disclosed in numerous regulatory filings and disclosure documents. Second, the NFA imposes examination requirements on persons who solicit discretionary accounts for CTAs and on those who supervise such persons; these "associated persons" are tested on the commodities markets generally, especially physical commodities, as well as CFTC regulations. This too is inappropriate for the employees of registered investment advisers. Such advisers employ commodities interests in the course of, and as an incident to, managing portfolios of securities. To the extent that commodity interests would be discussed in a sales presentation, it would be to explain the role of such interests in the management of securities portfolios. In addition, many of such persons are already registered with the NASD and have taken NASD and other examinations appropriate to the products they are licensed to sell.

Even more importantly, certain of the disclosure requirements imposed on CTAs are inapppropriate and misleading when applied to institutional managers of securities portfolios. For example, a CTA must provide its prospective clients with a Disclosure Document that states the actual performance record over the past three years for all accounts directed by the CTA and its principals. This requirement for presentation of past performance was designed to provide potential customers with useful information regarding an advisor's success in trading or providing advice regarding the trading of commodity interests for speculative purposes. But institutional advisors use commodities instruments (i.e., financial futures and related options) primarily for hedging and risk management. Thus their commodity trading performance records would be irrelevant and indeed misleading, since such records would have no meaning except in light of, and in conjunction with, the overall performance of the entire securities portfolio. And a large institutional adviser such as an insurance company would have numerous accounts directed by it and its many "principals," many of which are non-advisory accounts and involve strategies unrelated to the adviser's investment management business. Similarly, the Disclosure Document must include a lengthy and boldface "Risk Disclosure Statement" warning of the speculative nature of commodity futures trading. As already noted, however, institutional advisors use such futures to manage risk and in other non-speculative ways; hence the required warning would be misleading.

In short, the regulations applicable to CTAs are neither necessary nor appropriate to apply to institutional advisors using commodities interests in connection with the management of securities portfolios. Their imposition would also put institutional advisors at an unjustified competitive disadvantage. Insurance companies and other institutional advisors compete with banks and trust companies for the business of managing or advising large portfolios for clients such as pension plans, endowments, foundations, mutual funds, and others. Yet banks and trust companies are excluded from the definition of CTA in Section 2 of the Commodity Exchange Act. Thus, banks and trust companies are not subject to the very considerable expense, delay and inconvenience involved in CTA registration and regulation, including duplicative reports to the CFTC and NFA, fingerprinting requirements, and examinations. Indeed, we understand that the process of registering as a CTA with the NFA currently takes many months, a delay that is quite harmful from a business standpoint. In addition, banks and trust companies need not include the inappropriate and misleading materials required to be in a Disclosure Document, such as performance charts and Risk Disclosure Statements -- materials that undoubtedly would, for no valid reason, diminish the institutional advisor's ability to compete with banks and trust companies in developing business.

III. Requested Legislative Action

We believe that the Congress should amend the definition of CTA in 7 U.S.C. § 2 to add an exclusion for "any investment adviser registered as such with the Securities and Exchange Commission under the Investment Advisers Act of 1940 whose advice concerning commodities is in connection with the management of securities portfolios of institutional investors (including but not limited to banks, insurance companies, registered investment companies, financial institutions, corporations, charitable foundations, and single-employer and multi-employer employee welfare, pension and profit sharing plans and trusts)."[2] This would put registered institutional investment advisers doing such a business on the same competitive footing as banks and trust companies. The exclusion would permit registered institutional investment advisers to use financial futures and related options in the management of equity and debt portfolios of institutional clients. In addition to the fully adequate regulation applicable to registered advisers, the fact that the proposed exclusion is limited to institutional investors provides further protection. Such investors are generally subject to their own regulatory schemes regarding permissible investments (as the CFTC's Rule 4.5 recognizes) and are, in any event, sophisticated investors.

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[2] Thus, Section 2(a)(1)(A) of the Commodity Exchange Act would be revised in pertinent part as follows:

> "The term 'commodity trading advisor' shall mean any person who, for compensation or profit, engages in the business of advising others, either directly or through publications, writings or electronic media, as to the value of or the advisability of trading in any contract of sale of a commodity for future delivery made or to be made on or subject to the rules of a contract market, any commodity option authorized under section 4c, or any leverage transaction authorized under section 19, or who, for compensation or profit, and as part of a regular business, issues or promulgates analyses or reports concerning any of the foregoing; but such term does not include (i) any bank or trust company or any person acting as an employee thereof, (ii) any news reporter, news columnist, or news editor of the print or electronic media, or any lawyer, accountant, or teacher, (iii) any floor broker or futures commission merchant, (iv) the publisher or producer of any print or electronic data of general and regular dissemination, including its employees, (v) the fiduciary of any defined benefit plan which is subject to the provisions of the Employee Retirement Income Security Act of 1974, (vi) any contract market, (vii) any investment adviser registered as such with the Securities and Exchange Commission under the Investment Advisers Act of 1940 whose advice concerning commodities is in connection with the management of securities portfolios of institutional investors (including but not limited to banks, insurance

(FOOTNOTE CONTINUED)

As an alternative, the Committee could, by language in its Report, propose that the CFTC take regulatory action excluding such advisers from the definition of a CTA. The CFTC already has the power to exclude from the definition of a CTA "such other persons not within the intent of this definition." 7 U.S.C. § 2. In 1982, the Senate Agriculture Committee concluded not to adopt an amendment exempting certain otherwise regulated persons using futures or options for limited purposes from the statutory definition of "commodity pool operator," but instead expressed its view that such persons were not within the intent of the definition of that term. S. Rep. No. 384,

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companies, regist~~ered~~ investment companies, financial institutions, corporations, charitable foundations, and single-employer and multi-employer employee welfare, pension and profit sharing plans and trusts), and (viii) such other persons not within the intent of this definition as the Commission may specify by rule, regulation, or order: Provided, That the furnishing of such services by the foregoing persons is solely incidental to the conduct of their business or profession: Provided further, That the Commission, by rule or regulation, may include within this definition, any person advising as to the value of commodities or issuing reports or analyses concerning commodities if the Commission determines that such rule or regulation will effectuate the purposes of this provision."

97th Cong., 2d Sess. 80 (1982). Thereafter, the CFTC on February 8, 1984 proposed a rule creating such an exemption, and a final rule was adopted on April 23, 1985.

We believe that either direct legislation or a specific proposal of regulatory relief by this Committee to the CFTC is necessary to ensure an expeditious resolution to these problems, which is vital. The Commission has long been aware of the problem of CTA registration and regulation for institutional investment advisers. Indeed, when it proposed the CPO exemption for otherwise regulated entities on February 8, 1984, the CFTC indicated that "in furtherance of the purpose of the [Senate] Committee Report" it was considering providing some (albeit inadequate) exemptive relief for otherwise regulated entities from CTA registration and regulation. But despite receiving comments at that time urging that such regulated entities be excluded from the definition of CTA, the CFTC has yet to propose any rule on the issue. Nor has adequate relief been given through individual exemptions or no-action positions.

As just noted, the Commission's February 8, 1984 proposal for relief on the CTA issue was plainly inadequate. The proposed exemption would have been limited to advisors formed for the sole purpose of providing advice to a single entity that qualified for exclusion from the definition of commodity pool under Rule 4.5. That limitation, however, had no justification. The facts that an advisor was formed long ago for another purpose (e.g., to conduct a life insurance business), and that it advises more than one client, have no relationship to whether regulation as a CTA is necessary or appropriate. As discussed above, in fact, such regulation is neither in these circumstances.

The CFTC has similarly adopted an overly narrow view of the Act's exclusion from the definition of a CTA of "the fiduciary of any defined benefit plan which is subject to the provisions of" ERISA. 7 U.S.C. § 2. It is clear that insurance companies or other institutional investment advisers to defined benefit plans, as the "designated investment manager," 29 U.S.C. § 1002(38), are fiduciaries as to each such plan. Yet the CFTC has adopted regulations which purport to limit the statutory exclusion to the "named fiduciary, the trustee, or any fiduciary whose sole business is to advise the plan." 17 C.F.R. § 1.3(hh). This limitation, again, is not justified. Regulation of investment manager-fiduciaries under ERISA is not decreased either because the fiduciary is not named or because such management is not the fiduciary's sole business. We believe that the CFTC's attempt to restrict the statutory exclusion for ERISA fiduciaries of defined benefit plans should be disapproved by the Committee. In any event, however, this unjustifiably narrow interpretive regulation confirms our view that legislation or other direction to the CFTC from this Committee is needed regarding the inappropriateness of subjecting registered investment advisers to regulation as CTAs simply because they use futures in managing institutional securities portfolios.

Decisive action by this Committee -- whether by legislation or by advising the CFTC to use its existing exemptive authority -- is also needed because the need for relief from these inappropriate registration and regulation requirements is becoming critical. Institutional advisors are presently relying on the exemption from registration for advisors with no more than 15 clients, but that limit is fast approaching for at least some of the advisors. Once the limit is reached, such advisors will unfairly have to choose between undergoing the registration process and complying with ill-suited regulations or foregoing clients who wish to take advantage of the new and beneficial techniques for risk management made possible by the use of commodities interests. Such a choice obviously puts insurance companies and other institutional investment managers at an unjustified competitive disadvantage as against banks and trust companies. It also inappropriately prevents insurance companies and other institutional money managers from making such services available to their current clients.

Accordingly, we respectfully urge the Committee to amend Section 2 of the Commodity Exchange Act to provide an exclusion for registered investment advisers whose advice concerning commodities is in connection with the management of institutional securities portfolios, or, at a minimum, to advise the Commission in the Committee's Report of the importance of proceeding forthwith to grant exemptive relief to such advisers.

Respectfully submitted,

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WRITTEN STATEMENT OF HARVEY KOCHEN, VICE PRESIDENT INTERNATIONAL PRECIOUS METALS CORPORATION

This statement is submitted by Harvey Kochen on behalf of International Precious Metals Corporation ("IPMC"). IPMC is a leverage transaction merchant, registered under the Commodity Exchange Act (the "Act").

IPMC has approximately 200 employees and has offices in Fort Lauderdale, Florida, Boca Raton, Florida and Newport Beach, California. IPMC has been in the business of selling precious metals to the public through leverage contracts for over twelve years. At the present time, IPMC has approximately 2,400 leverage customers.

This is the fourth time in twelve years that IPMC has submitted material to Congress seeking a settled regulatory atmosphere in which to conduct our business. Notwithstanding the successful implementation of comprehensive regulations in 1982 as directed by Congress, the Commodity Futures Trading Commission has now proposed that Congress eliminate the regulation of leverage transactions from the Act. It is the Commission's view that leverage contracts and futures contracts are legally and economically indistinguishable and therefore do not justify separate statutory treatment.

This view is of course contrary to reality, contrary to the findings of Congress, as evidenced in the prior legislative history of the Act and its various amendments, and is also contrary to the findings of the Commission's own Advisory Committee in 1976.

As a legitimate business enterprise serving the demands of a segment of the investing public for over ten years, IPMC has faced continuing frustrations and has incurred very substantial expense due to the unsettled regulatory environment regarding leverage contracts. The history of the regulation of leverage contracts reflects the continuing reluctance of the CFTC to adhere to the mandates of Congress and to regulate (rather than prohibit) leverage contracts as a federally regulated commodity instrument. A brief review of that history will help demonstrate that the CFTC's present position is entirely inappropriate.

HISTORY OF THE REGULATION OF LEVERAGE CONTRACTS

In 1974, Congress included within the charter of the new CFTC the regulation of companies engaged in the sale of commodities through leverage contracts. Section 217 prohibited any person from entering into a leverage transaction contrary to any CFTC regulation designed to ensure the financial solvency of the transaction or to prevent manipulation or fraud. The Conference report clearly directed the new CFTC to regulate these transactions.

Shortly after the CFTC was created in April 1975, it adopted a stopgap antifraud regulation for leverage transactions. IPMC strongly supported this regulation and in comments to the CFTC urged in addition that the Commission "move swiftly to adopt additional comprehensive regulations under Section 217".

On August 20, 1975, the CFTC proposed a temporary rule to regulate leverage transactions pending a more comprehensive review of the industry, but the proposal was never acted upon. In the meantime, the CFTC empaneled a seventeen-person Advisory Committee to study and make recommendations on the Commission's jurisdiction over futures, forward and leverage contracts.

On July 16, 1976, the CFTC Advisory Committee on Market Instruments, after almost a year of study, including several public hearings, published an exhaustive report including findings that leverage transactions (a) are distinct from traditional exchange-traded futures transactions and should not be regulated as such futures contracts, (b) are not inherently fraudulent or manipulative, and (c) could not and should not be prohibited. The Committee also proposed specific and comprehensive recommendations to the CFTC for leverage transaction regulations.

Shortly thereafter, on September 18, 1976, the CFTC's General Counsel endorsed the Advisory Committee findings and recommendations. The following week, on October 4, 1976, the CFTC considered the findings and voted to regulate leverage transactions in accordance with the recommendations of the Advisory Committee. At that meeting, the Commission directed its staff to prepare regulations for publication.

Over a year later, at a meeting held November 8, 1977, the CFTC discussed the status of the proposed regulations and decided more "study" of the leverage business was necessary in order to help the Commission draw a distinction between leverage contracts and futures contracts. The staff was directed to conduct the study and return to the Commission "within four weeks". But no study was returned in four weeks.

In another three months, before the staff "study" was finished and in an abrupt reversal of its course, the CFTC asked this Committee to repeal Section 217. The CFTC Vice Chairman, on February 21, 1978, summarized the Commission's position on reauthorization of the leverage authority saying, "Frankly, I think the judgment was made by the Commission that leverage was not worth the trouble we were going through in trying to define it. Therefore I think we are coming back to you and asking you to take us off the hook."

During that reauthorization, IPMC and its major competitors asked Congress not to reopen the "regulatory gap" that had existed prior to 1974 by repealing Section 217, but to direct the CFTC promptly to regulate the leverage business. On August 17, 1978, House and Senate conferees rebuffed the Commission's proposal, agreed to expand its jurisdiction over leverage transactions involving all commodities, and directed the Commission once again to regulate leverage transactions. The draft Conference Report stated succinctly enough, "It is the intent of the conferees that the Commission act expeditiously . . . to regulate . . . leverage transactions in gold and silver."

Nevertheless, after the Committee had adjourned but before the report had been adopted, and in a last minute effort to circumvent the action of the conferees, the Commission deliberately put Congress on notice that all leverage transactions could be banned by the CFTC utilizing its authority under proposed section 19(d) as an alternative to regulating the industry. This, they reasoned, would force Congress "to clarify" its intentions with respect to Section 19.

In response, language was added to the Conference Report stating: "In this regard, the Commission's authority to determine that any gold or silver leverage contract is a contract for future delivery . . . is not to be casually exercised as a substitute for the regulation of that leverage contract . . . The conferees did not contemplate, based on prior representations by the Commission, that the Commission would classify all gold and silver leverage contracts as contracts for future delivery."

The Commission failed to follow this instruction. First, on December 5, 1978, the CFTC took final action on a "temporary" moratorium on the entry of new firms into the gold and silver leverage transaction business. The "temporary" moratorium was made effective June 1, 1978, and has not been lifted to this day, so that the entry of new competition into our business has been prevented. On February 2, 1979, the CFTC imposed another "temporary" moratorium on the sale of any commodities other than gold or silver by either existing leverage firms or any new firms. This moratorium also remains in effect today, freezing even product competition among the few companies allowed to engage in the leverage business.

In a good faith effort to expedite the Commission's compliance with Congress' instruction to regulate, on February 14, 1979, two major leverage firms, IPMC and Monex International Ltd., submitted to the CFTC a joint rulemaking position including comprehensive proposed leverage regulations. In March, notice of the proposed ban -- the determination that leverage contracts are futures contracts within the meaning of the Act -- was published by the CFTC. Subsequently, notice of the availability of the industry petition was published in April. In the meantime, in spite of overwhelmingly negative comments received in response to the proposal that leverage contracts were actually futures contracts, the CFTC published notice on July 27, 1979, of its intention so to determine, effective January 1, 1980. The Commission, without any consideration of the impact upon thousands of leverage customers, acknowledged that this action would constitute a ban on all leverage transactions.

Since it was apparent the Commission was still ignoring the instructions it had received, Chairman Talmadge and Senator Helms on behalf of the Senate Committee on Agriculture, Nutrition and Forestry, and Chairman Foley and Representatives Wampler, Jones and Madigan, on behalf of the Committee of which this Subcommittee is a part, sent letters to the CFTC on November 15 and 16, 1979, respectively, reminding the Commission of its regulatory mandate under Section 19, urging the Commission to reconsider its proposed ban, and warning the Commission against trying to ignore its own deadline on Congress.

In response to this letter, the CFTC met on December 3, 1979 and voted to postpone the effective date of its proposed ban on leverage transactions until June 30, 1980. On May 28, 1980, the CFTC voted again to postpone its proposed ban, this time until October 1, 1982. Purportedly, this would give Congress yet another opportunity to clarify its intentions. The CFTC directed its staff to develop "interim" regulations to protect the public in the meantime.

These regulations were to be published and effective not later than December, 1980, but once again the staff failed to act. Then, at a meeting on April 28, 1981, almost a year later, the CFTC finally considered specific proposals for "interim" regulations. The Commission approved them and directed the staff to prepare a Federal Register notice publishing the specific regulations.

As part of the 1982 reauthorization process of the CFTC, Congress again directed the CFTC to regulate leverage transactions as a distinct category of commodity transactions and to regulate the leverage transaction business not subject to CFTC moratoria. In response, the CFTC finally promulgated extensive regulations (denominated as "interim" regulations by the CFTC) governing leverage transactions, which became effective in June 1984. Although onerous, the leverage transaction rules have successfully provided a workable regulatory framework in which leverage customers have been adequately protected and the leverage transaction merchants have continued in business.

With these regulations in place and operating successfully, it is incongruous for the CFTC to again return to Congress and ask that leverage contracts be banned as off-exchange futures contracts. Moreover, it has been demonstrated time and time again that leverage contracts are not the same as futures contracts.

LEVERAGE CONTRACTS ARE NOT THE SAME AS FUTURES CONTRACTS

Since the adoption of the Commodity Futures Trading Commission Act of 1974, Congress has recognized that leverage contracts are different instruments from futures contracts. Congressional recognition of the critical characteristics of leverage contracts was most clearly expressed in the Report of Senate Committee on Agriculture, Nutrition and Forestry, S. Rep. 850, 95th Cong., 2d Sess. 26 (1978), as follows:

> "Generally, the leverage contract currently in use is an agreement for the purchase or sale of a contract for the delivery at a later date of a specified commodity in a standard unit and quality, or the close-out of the contract by an offsetting transaction. The principal characteristics of the contract include: (1) standard units, quality, and terms and conditions; (2) payment and maintenance of 'margin'; (3) close-out by an offsetting transaction or by delivery, after payment in full; and (4) no right or interest in a specific lot of the commodity. The leverage dealer is the principal to every transaction and functions as a market maker. The leverage dealer, however, does not guarantee a repurchase market and further reserves the right to cease operating as a market maker or broker for the customer. Most customer commitments are covered or 'hedged' in futures, forwards, or physical inventory; most physical inventory, however, is encumbered through bank loans. Leverage contract bid/ask prices are determined by dealer adjustments to spot and futures market quotations."

There are clear legal distinctions between leverage contracts and futures contracts: a leverage contract is a contract to purchase a commodity for delivery at a later date at any time during a specified period, and is margined with a down payment that reduces the unpaid balance; a futures contract, on the other hand, is a contract to purchase a spot contract at a specified time, and is margined with a performance deposit.

There are also significant economic differences between the two. The futures contract is designed primarily as a hedging vehicle and not for delivery. The buyer of a long futures contract chooses the delivery month when the contract is entered into; and then it is the seller, not the purchaser, who controls the actual delivery. The leverage contract is designed for flexible delivery. The buyer of a leverage contract makes the purchase and then decides when to take delivery at any time during an extended time period. The choice of time and place of delivery belongs to the leverage contract buyer.

Moreover, leverage contract pricing is based on the current spot or cash market, as opposed to futures pricing which is based on a deferred delivery month. Leverage contract prices are based on discovery from other verifiable, publicly available market sources, validated with an immediate time-stamping audit trail. Leverage contract prices are not restricted by limit moves, which can trap an unwary investor.

Leverage contracts are also treated in a different manner than futures contracts for tax purposes, in recognition of the significant economic and legal differences between the two.

There are numerous other distinctions between leverage contracts and future contracts. We believe that the Report of the Advisory Committee on Market Instruments to the Commission entitled "Recommended Policies on Futures, Forwards and Leverage Contracts and Transactions" includes a generally accurate comparison, at pages 18-22, of certain significant elements of futures contracts and leverage contracts. That chart is attached as Exhibit A.

On the basis of the Advisory Committee Report, it was determined that a separate regulatory scheme applicable to leverage contracts should be adopted. Many of the Advisory Committee's recommendations are now embodied in the leverage transaction rules.

A further explanation of significant economic and other distinctions between leverage contracts and futures contracts is contained in the study entitled "The Commodity Leverage Contract: An Economic Analysis," prepared for IPMC in 1978 by Dr. Roger W. Gray and Dr. David J.S. Rutledge, attached as Exhibit B.

The CFTC's attempt to avoid continuing responsibility for regulation of leverage contracts might be understandable if it could be demonstrated that the public interest would be better served by delegating this responsibility to the states as suggested by the CFTC. There are two fundamental flaws in this position - first, the federal regulation of leverage transaction is working, and second, the regulation of leverage contracts is properly a matter within the exclusive jurisdiction of the CFTC.

FEDERAL REGULATION OF LEVERAGE TRANSACTIONS IS WORKING EFFECTIVELY

Prior to the issuance of the regulations in 1984, IPMC on a voluntary basis followed practices which included, among others, 100 percent cover of its delivery obligations, complete segregation of customer funds and disclosure of the terms and conditions of its leverage contract. Unfortunately, some commodities merchants selling similar commodity instruments did not follow these practices and a number of customers suffered as a result of the financial failure of these merchants or their fraudulent practices.

With the adoption of the comprehensive federal leverage regulations, the investing public is now protected in these regulated off-exchange transactions. These leverage customer protections include:

1. A minimum adjusted net capital requirement of $2,500,000, with an early warning level of $3,000,000;
2. Segregation of leverage customer funds from the funds of the leverage transaction merchant;
3. Cover by the leverage transaction merchant of its obligations to its customers;
4. The registration of the leverage transaction merchant, its principals, officers, directors, sales representatives and sales supervisory personnel, the leverage commodities it offers, and its customer disclosure documents and customer account agreement forms; and
5. Unprecedented commodity customer safeguards which include the limited right of rescission for a first-time customer, the limited right of re-establishment (without charges or fees) of a liquidated undermargined position and mandatory break-even disclosure.

These regulations, while unduly burdensome in certain respects, are clearly very effective in meeting their objectives of providing the customer with adequate disclosure, protection from manipulation and fraud and, most important, insuring the financial solvency of the transactions.

IPMC has not had a single customer reparations complaint or civil litigation suit brought against it by a leverage customer whose account has been established under these new leverage rules.

At the same time as the leverage rules have been implemented, IPMC is aware that certain commodities operations regulated only by the states have continued to engage in fraudulent practices and have cost the investing public substantial sums of money. Customers of these operations have not been afforded the same regulatory protections as leverage customers and we think that the public interest is better served by maintaining the CFTC's exclusive jurisdiction.

THE REGULATION OF LEVERAGE CONTRACTS IS PROPERLY WITHIN THE EXCLUSIVE JURISDICTION OF THE CFTC

Leverage contracts are based upon the national and international commodities markets and are inherently a matter properly the subject of federal, rather than state, regulation. Withdrawing the federal leverage rules would effectively ban this business. This would not only be detrimental to the participants in the leverage industry, but would adversely affect thousands of investors who use leverage contracts as a means of investing in the precious metals market. IPMC could not convert its margin-type business into a physical cash delivery business to fit within state regulations to enable it to continue its operations, as suggested by the CFTC.

The CFTC-promulgated leverage transaction rules have provided a regulatory framework for this commodity contract. The states do not have effective laws to regulate this area, nor are they uniform. The states' legislation is designed to ban leverage transactions to the extent that they are not operated within the scope of federal regulations. Denying leverage transaction merchants exclusive federal regulation exposes leverage transactions to a plethora of inconsistent state regulations that would effectively prohibit leverage transaction merchants from operating on a nationwide basis. It is disappointing to think that Congress would even consider adopting legislation that would withdraw an existing regulatory framework that is working, the result of which would deny the public the protection of these laws.

IPMC recognizes that the CFTC has scarce resources, and that the regulation of leverage contracts has been time-consuming and expensive. Accordingly we believe the public interest can be better served by the delegation by the CFTC of the direct regulation of the leverage industry to a designated self-regulatory organization, operating under the oversight of the CFTC.

The National Futures Association has acknowledged that it could regulate leverage transactions if directed to do so, and we believe the NFA is the appropriate organization since it already has the systems and personnel in place with respect to the regulation of every other federally-regulated category of commodity industry registrant that deals directly with the public. To the extent that regulatory responsibility for leverage would increase the NFA's operating costs, they could be recovered through membership fees for leverage merchants and their personnel. IPMC is certainly willing to pay its fair share of these costs and would welcome the opportunity to participate in the development of self-regulatory proposal for leverage merchants.

This brings up a final point. Due to the CFTC moratoria, the legitimate leverage industry currently consists of only two firms, IPMC and Monex International Ltd.

As observed in the Conference Committee in connection with the CFTC reauthorization in 1982, there moratoria are "inherently anticompetitive and thus contrary to the fundamental objectives of economic competition and the free marketplace." With effective regulations in place, there is no valid reason for continuing the moratoria and IPMC therefore urges Congress to direct the CFTC to lift these moratoria and permit entry of qualified firms as expeditiously as possible.

IPMC is grateful for this opportunity to express its views before this Committee. IPMC is willing to further assist this Committee in its evaluation of the leverage industry and will expeditiously respond to any such request.

(Attachments follow:)

RLS46a

EXHIBIT A

A COMPARISON OF SOME SIGNIFICANT ELEMENTS OF FUTURES CONTRACTS, FORWARD CONTRACTS AND LEVERAGE CONTRACTS *

Each contract is for the purchase and sale of a commodity to be delivered in the future. Different elements of each are as follows:

	FUTURES	FORWARD	LEVERAGE
1. Traded publicly through a central market place	Yes	No	No
2. Pricing	Competitive open outcry	Private negotiation	Announced by one party
3. Settlement by delivery	Minimally (1)	Usually	(2)
4. Cleared through and liability of parties assumed by central clearing house	Yes	No (3)	No
5. Public Participation	Substantially	Infrequently	Almost exclusively (4)
6. Trade Participation	Substantially	Predominantly	Almost never (4)
7. Contract terms:			
(a) Contract terms standardized by independent agency (e.g., exchange or association)	Mandatory	Optional (5)	No
(b) Contract terms standardized by single contracting party	No	In some cases (6)	Yes
(c) Quality	Standardized by exchange with premiums and discounts	As agreed to following negotiation by the parties	Standardized by each contract writer

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*For convenience, the chart has been footnoted separately from the Report.

	FUTURES	FORWARD	LEVERAGE
7. (Cont'd)			
(d) Minimum lot size	Standardized by exchange	None	Standardized by each contract writer
(e) Delivery points	Standardized by exchange	As agreed to following negotiation by the parties	Standardized by each contract writer
(f) Delivery period	Standardized by exchange	As agreed to following negotiation by the parties	Standardized by each contract writer
(g) Delivery date	Seller's option (subject to 7(f) above)	As agreed to following negotiation by the parties	Buyer's option (subject to 7(f) above)
(h) Terms of payment	Standardized by exchange	As agreed to following negotiation by the parties	Standardized by each contract writer
8. Independent quality verification (e.g., assaying, sampling, etc.)	Yes (7)	As agreed to following negotiation by the parties	Not standardized but available at a fee
9. Payment or deposit at time of contracting	Security deposit (original margin)	No (8)	Partial payment (long contract); security deposit (short contract) (9)

	FUTURES	FORWARD	LEVERAGE
9. (Cont'd)			
(a) Held by third party (e.g., clearing house and/or FCM segrogated account)	Yes	No (3)	No
(b) Paid or deposited by both parties	Yes	No (8)	No
(c) Paid or deposited by one party only	No	No	Yes
10. Additional payments or deposits, or withdrawals	Yes	No (8)	Yes (10)
(a) Daily "marking to market" (i.e., market value calculated daily)	Yes	No (6)	Yes
(b) Daily debit or credit for (a) alone	Yes	No (8)	In some cases
(c) Settlement of daily debits or credits through a clearing house (sometimes referred to as a "variation margin")	Yes	No	No
(d) Basis for additional payments or deposits, or withdrawals	Specified by rules of contract market and/or FCM	No (8)	Specified by contract (11)
11. Interest or other periodic fees	No	As agreed to following negotiation by the parties	Yes (12)

	FUTURES	FORWARDS	LEVERAGE
12. Force majeure provisions	Standardized by exchange	As agreed to following negotiation by the parties	Standardized by each contract writer

NOTES:

1. In some commodities with light trading volume, a relatively high proportion of contracts initially traded culminate in delivery.

2. Experience to date is insufficient to make a meaningful generalization.

3. Until recently, it was possible to clear and margin forward contracts in rubber through the Rubber Trade Association. That facility has been suspended for the time being.

4. One dealer in leverage contracts stated at a subcommittee meeting that in rare instances leverage contracts are used by small miners, coin dealers and small jewelry manufacturers as a hedging device.

5. Standardized trade association contracts are available (but not mandatory) in some commodities.

6. Certain large dealers and industrial users prescribe their own standard forms, although the terms may be open to negotiation.

7. Brand names, registration numbers and other evidences of quality may be accepted in lieu of independent quality verification.

8. Although forward contracts are not normally margined as such, the contracting parties may arrange for mutual or unilateral securing of open obligations, and such arrangements may include guarantees, performance bonds or letters of credit whereby third parties are involved.

9. Reference to short leverage contracts should not be construed to mean that the Advisory Committee expresses any opinion whether such contracts are within the scope of §217 of the CFTC Act.

NOTES: (Cont'd)

10. Normally the writer of a leverage contract does not make cash payments as the market moves against him, but in some cases he may make such payments to a particular customer to the extent he has previously received Item 10(a) payments from that customer.

11. Withdrawals are permitted only in some cases subject to contract.

12. The Advisory Committee expresses no opinion whether periodic fees, whatever called, constitute interest.

EXHIBIT B

The Commodity Leverage Contract: An Economic Analysis

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and

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June, 1978

1. INTRODUCTION

The leverage contract is a relative newcomer to the investment scene in the United States. It has been described in the following terms

> "Generally, the leverage contract currently in use is an agreement for the purchase or sale of a contract for the delivery at a later date of a specified commodity in a standard unit or quality, or the close-out of the contract by an offsetting transaction. The principal characteristics of the contract include: (1) standard units, quality, and terms and conditions; (2) payment and maintenance of margin; (3) close-out by an offsetting transaction or by delivery, after payment in full; and (4) no right or interest in a specific lot of the commodity." 1/

According to a recent staff survey conducted by the CFTC, trading in leverage contracts in silver and gold may account for an open customer commitment of as much as $100 to $150 million. Additionally, there is a growing volume of leverage transactions in other commodities such as platinum, copper, foreign currency and investment diamonds.2/

Relatively little is known about the market structure and conduct of the leverage contract industry. Under Section 217 of the Commodity Exchange Act (as amended) the CFTC was empowered to regulate leverage transactions in silver and gold. In August 1975 the Commission established an Advisory Committee on Definition and Regulation of Market Instruments to, inter-alia study and make recommendations on the definition and regulation of leverage transactions. The deliberations of this Committee were somewhat hampered by lack of hard data relating to this industry, but it nevertheless suggested a framework within which the industry might be regulated by the Commission.

To the present time the Commission has not promulgated regulations for these

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1/ Commodity Futures Trading Commission, Press Release, April 27, 1978, pp. 1-2.

2/ Ibid., p. 1

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contracts. Indeed in reauthorization hearings before Congress earlier this year the Commission sought to have Section 217 repealed. Further, in an internal memorandum dated May 8, 1978, the Acting Chief Economist of the Commission argued that leverage contracts are essentially futures contracts, a finding which, if accepted, would have significant implications for the industry and its regulation. Most recently the Commission last month imposed a moratorium on new firms entering the industry.

The present study is intended to shed some futher light on the operation of this industry. In particular it considers the following questions:

(a) What, if any, are the peculiar economic characteristics of the leverage contract which distinguish it from other forms of investment in commodities?

(b) How does the leverage contract compare to other forms of investment from the viewpoint of the investor?

(c) What is the economic basis of the fee structure used by firms in this industry?

(d) How are prices of leverage contracts determined?

(e) What practices are followed with respect to such things as coverage, segregation of accounts and compliance?

In addressing these questions we have relied not only on the general body of literature in commodity economics but also on data provided by International Precious Metals Corporation (IPMC), a leading firm in the industry. Our analysis and conclusions are therefore limited to the extent that IPMC's operations may not be representative of the industry as a whole. In particular, as IPMC deals only in long leverage contracts, and only in gold and silver bullion and coins, our analysis may not apply directly to short contracts and to other commodities.

2. THE LEVERAGE CONTRACT AS AN INVESTMENT MEDIUM

In a later section of this study we shall discuss the nature of the leverage contract as an economic instrument pointing out the ways in which it differs from other forms of forward contracts. For the moment, however, we focus on the potential usefulness of the leverage contract to the purchaser of such a contract, and compare it with other forms of investment available to him. Our analysis is restricted to gold and silver, indeed, for the most part, to gold and silver bullion.

Leverage contracts provide a means for the small trader to invest in gold and silver. One might well question at the outset the rationale for such investment, although this issue goes beyond the purpose of the present study. Nevertheless it is clear to even the most casual observer that precious metals do provide some measure of protection against the ravages of inflation. It would be a brave person who would argue that significant inflation is unlikely to be a persistent phenomenon for the indefinite future. In any event, even in the absence of the leverage contract, there are several means whereby investors can include gold and silver coins in their portfolios.

While addressing this issue, however, it may be appropriate to point out one aspect which is often overlooked. In standard treatments of investment analysis [3] much is made of the desirability of including in one's portfolio assets whose returns are negatively correlated with each other. This enables the investor to reduce the risk associated with a given expected portfolio return or, equivalently, to increase the expected return associated with a given degree of risk. In pursuing this theme we correlated movements in the Dow Jones Industrials Average with the spot price of gold, finding a correlation of -0.843.[4] This suggests that precious metals may have a role to play in the portfolio of even a relatively small investor.

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[3] For example, W.F. Sharpe, Investments, Prentice-Hall 1978.

[4] Similarly large negative correlations were found between the price of gold and other major stock market indices. The data on which these figures are based are 129 weekly observations from January 1975 to June 1977.

Such an investor has available three alternative courses of action:

(a) Outright purchase;

(b) Purchase of futures contracts;

(c) Purchase of a leverage contract.

Of these, outright purchase has the advantage of virtually no minimum purchase size,[5] but the disadvantages of little or no leverage and possibly high transactions cost in the event of resale.

A comparison of futures contracts and leverage contracts, as we shall see below, involves more subtle distinctions but nevertheless very real ones from the viewpoint of the investor. Futures contracts in gold and silver bullion and coins are traded on several organized exchanges in North America. Details of the major contracts are summarized in Table 1. For purposes of comparison, Table 2 reports the minimum purchase quantities available in leverage contracts from IPMC. Clearly, smaller quantities are available via leverage contracts although this comparison is misleading because each involves a different degree of leverage. In fact, the initial capital requirement is approximately the same for each form of investment. At current market values an initial outlay of approximately $950 is required for the purchase of a leverage contract in silver bullion. To purchase a silver futures contract an initial outlay of approximately $1060 is required, except for the Mid-America Commodity Exchange where the corresponding figure is approximately $550. Very similar figures apply to gold. Thus, with the exception of futures transactions on the Mid-America Exchange, much the same initial outlay is required for both futures and leverage transactions. It may be noted, however, that trading in gold and silver at

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[5] For example IPMC requires a minimum cash purchase of $500.

Table 1

Major Features of Futures Contracts in Gold and Silver [a]

	Gold		Silver	
Exchange	Contract Size[b]	Average Monthly Trading[c] Volume, Jan '78-Apr'78 (contracts)	Contract Size	Average Monthly Trading Volume, Jan '78-Apr '78 (contracts)
Comex	100 oz.	211283	5000 oz	319789
IMM	100 oz	182352	(d)	
CBT	3 kilo	393	5000 oz	232134
Mid-America	1 kilo	390	1000 oz	35507
Winnipeg	400 oz	1284	(d)	

Notes

(a) Futures contracts for U.S. Silver Coins are traded on IMM and Mid-America, and for Gold Bullion on New York Mercantile Exchange. However, these contracts are relatively inactive at the present time.

(b) 1 kilo equals 3.11 troy ounces.

(c) Data on trading volume for Comex, IMM, CBT and Mid-America obtained from Futures Industry Association Monthly Bulletin No. 3380. For Winnipeg, data obtained from Wall Street Journal.

(d) No silver contract traded.

Table 2

IPMC Leverage Contracts: Minimum Purchase Quantities

Product	Minimum Purchase Quantity
Silver	500 oz
Gold	0.5 kilo
Silver Clad Coins	2 bags
U.S. 90% Silver Coins	1 bag
U.S. 20 dollar Coins	20 coins
British Sovereign Coins	80 coins
Mexican 50 Peso Coins	20 coins
Krugerrand Coins	20 coins

the Mid-America Exchange is considerably less active than at the major exchanges, with the consequence that any given transaction is more likely to have a price effect. Furthermore the above calculations do not take into account the fact that many brokerage houses require a customer to deposit an initial sum of several thousand dollars before servicing his futures transactions.

While the minimum initial outlay is similar for the two instruments, the risk exposure is most certainly not. Since the futures contract is more highly levered than the leverage contract, an adverse price movement will erode the capital position of a futures trader two or three times as fast as that of the leverage contract customer. It is presumably easier, therefore, for the small investor to manage his overall risk exposure via a leverage contract than by trading futures.

Another major respect in which futures and leverage contracts differ from the investor's viewpoint is the time over which a position may easily be held. Leverage contracts are long-term contracts with delivery as far forward as ten or even twenty-five years. While it is true that relatively few contracts will be held for the full term the fact that the opportunity exists to do so cannot be dismissed as irrelevant. Furthermore, analysis of a sample of leverage contract accounts suggests that these contracts are held open considerably longer than are futures contracts.[6/] While it may be possible to hold futures contracts over long periods of time it is frequently inconvenient to do so. Distant futures contracts are generally less actively traded than are nearbys. Furthermore, the contango structure in gold and silver futures markets reflects the term structure

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6/ A sample of 719 IPMC accounts on March 8, 1978 showed an average account life of 11.5 months.

of interest rates which typically means that spreads widen as we go into the more distant contracts. This is demonstrated in Table 3. As a result it becomes more expensive to trade in distant rather than nearby futures. The alternative, of course, is to purchase the nearby future and to "roll over" the position as the delivery date approaches. However this involves additional commission expenses, while at the same time there is no guarantee that an unfavorable price movement will not occur at the time the position is moved forward.

We do not wish to suggest that the leverage contract is inevitably a superior form of investment to the futures contract as far as the small investor is concerned. It suffers from several additional disadvantages. The leverage transaction merchant (LTM) is under no obligation to buy back the contract, although IPMC has always done so at its current bid price. Nevertheless in theory, there is no guaranteed resale market. Also, the leverage customer incurs further fees, a retail mark-up and the annual service fee, which means that a greater price increase is required for him to earn a profit. What we have argued, however, is that the leverage contract and the futures contract differ as an investment medium in a variety of ways and that consequently the leverage contract may on occasion better suit the requirements of some investors.

3. THE LEVERAGE FEE

One particular characteristic of the leverage contract which has caused confusion in the minds of some observers is the "leverage fee" or "carrying charge." This fee is charged to recoup expenses incurred

(a) as interest paid on financing physical inventory;

(b) as storage charges on physical inventory;

(c) as insurance costs on physical inventory

Table 3

Comparison of Nearby and Distant Futures Price Spreads

A. IMM Gold Bullion, August 1976

	Dec 76-Sep 76	Mar 77-Dec 76	Jun 77-Mar 77
$/oz	0.791 (0.725%)	1.255 (1.142%)	1.832 (1.622%)

B. Comex Gold Bullion, April 1978

	Aug 78–Jun 78	Dec 78–Oct 78	Apr 79-Feb 79
$/oz	2.242 (1.273%)	2.374 (1.314%)	2.689 (1.450%)

C. CBT Silver Bullion, September 1976

	Dec 76–Oct 76	Apr 77-Feb 77	Oct 77-Aug 77
$/oz	1.624 (0.376%)	4.034 (0.922%)	4.693 (1.042%)

D. Comex Silver Bullion, April 1978

	Sep 78-Jul 78	Mar 79-Jan 79	Jul 79–May 79
¢/oz	7.658 (1.470%)	8.237 (1.513%)	8.531 (1.520%)

Notes:

Spreads are calculated from monthly averages of daily closing or settlement prices. Data are from IMM 1976/77 Yearbook, Chicago Board of Trade 1977 Statistical Annual and Wall Street Journal.

(d) commissions on futures contracts;

(e) contango expense.

IPMC bases the leverage fee on the client's unpaid daily balance. The fees are billed quarterly, currently at an annual rate of 9 7/8 percent.

The question often raised is the following--"if the leverage merchant does not hold an inventory of the commodity being merchandised how can he validly charge a fee which is claimed to be a 'carrying charge'? Is this not a fictitious charge?"

Of course this question would not arise if the leverage transaction merchange (LTM) did in fact hold physical inventory to cover the full extent of his leverage sales. In that case he would incur out-of-pocket expenses such as interest, storage costs, and insurance which would in the normal course of events be passed on to his clients.

At the other extreme it is possible to visualize the case of a LTM who holds no inventories of the commodity in question and who does not cover his client position in any way. In this case no carrying charge would be justified. However, the merchant in this situation would be an outright speculator with a (presumably large) net short position. His net worth is reduced by any increase in prices. In this case the client is simply betting against the LTM. It is highly likely that such a merchant would remain in business for a short time only and the leverage contracts sold by him to the public would be of very dubious value as an investment medium. In fact, however, this is not the way in which the leverage firm studied in this paper carries out its business.

Although only a relatively small proportion (generally 15-25 percent) of the firm's client position is covered by inventory of the commodity itself, the firm has a very strict policy of covering the remainder of its short position with purchases of futures contracts. This hedged position must of course be "rolled over" from time to time as futures contracts are not traded as far into the future as the term of the leverage contract. This rolling over will normally be undertaken with a view to profiting from movements in inter-temporal price spreads but the underlying purpose of the futures position is clear and simple. By being fully hedged in cash and futures the LTM is essentially reducing his exposure to price fluctuation and hence ensuring his own financial integrity and thereby the integrity of the leverage contract itself. This important role of the LTM's hedging operation cannot be understated.

The question remains however as to what justification exists for LTM to levy a carrying charge for that portion of the client position which is covered in futures rather than actuals. The answer lies in the fact that in addition to brokerage fees incurred in futures operations the LTM incurs the expense arising from increases in spot prices relative to futures prices. The phenomenon, which is pervasive in gold and silver futures markets, is reflected in the array of futures prices in which spot prices are lower than nearby futures prices which in turn are lower than distant futures prices. In such a market structure it is inevitable that purchase of futures against cash or spot sales will result in a loss.

The extent of this loss (equivalent to the price spread between cash and futures prices) is predictable, because the price spread itself is determined by a basic economic law known as the "theory of the price of storage." This law, first discovered in the context of grain futures markets, has been found to be applicable to futures markets in all commodities for which continuous inventories are held.[7] In essence it states that the price spread between cash and futures prices (or between futures prices of contracts maturing at different dates) is a market determined price of storage. In the grains the major determinants of this price of storage are inventory costs and interest rates. In gold and silver interest rates dominate as the explicit storage costs and convenience yield of holding stocks are relatively minor.

This point is worth underlining because it demonstrates that these price spreads, and consequently losses incurred by LTM on its hedging operations, are not determined in an arbitrary fashion but rather are the outcome of a well-functioning market mechanism. Finally, to further illustrate this we have carried out a simple statistical analysis using data relating to the IMM gold bullion contract. Using 124 weekly observations the price spread (expressed as a percentage) between the two most nearby futures contracts was regressed against the appropriate interest rate, in this case the yield on 90-day Treasury Bills. The results are as follows:

$$SPR = -0.04188 + \underset{(0.00106)}{0.01331}\ IR$$

This equation accounts for 60% of the variation in the percentage price spread but considerably more (approximately 85%) of the variation in the flat price spread. This demonstrates clearly how price spreads (and contango expenses) in these markets are determined by exogenous economic forces.

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[7] H. Working, "Theory of the Inverse Carrying Charge in Futures Markets," Journal of Farm Economics, 30 (1948) pp. 1-28, and "The Theory of Price of Storage," American Economic Review, December 1949, pp. 1254-1262 (both reprinted in Selected Writings of Holbrook Working, Chicago Board of Trade (1977)). See also M.J. Brennan, "The Supply of Storage," American Economic Review, March 1958, pp. 50-72.

4. THE PRICING MECHANISM

Economists have long recognized the peculiar properties of prices determined in markets characterized by "perfect competition." These markets involve a large number of buyers and sellers, trading a homogeneous commodity, who have full information about all relevant market factors and who buy and sell freely amongst themselves. Very few "real world" markets approach this norm, with security markets and commodity futures markets probably doing so most closely.

The classic study of price behavior over time in these markets was carried out in 1949 by Holbrook Working [8] who argued that the extent to which market price promptly reflects all relevant information about commodity supply and demand can be measured by the randomness of price movements.

> "From our model we can also deduce something about the nature of the price fluctuations it will generate. The able and well-informed traders whom we have been considering make their profits by getting information that permits them to predict price changes. The information on which these predictions are made, however, so far as it is new and useful for price prediction, is itself unpredictable or nearly so. Consequently we may say, subject to slight qualification, that the price changes generated by the model are unpredictable price changes. That is, no change is predictable on the basis of the information that gives rise to the change. But this statement must be qualified because an important piece of new information must ordinarily generate a somewhat gradual price change, not an instantaneous one."[9]

Working's intuitive analysis was formalized by Professor Samuelson[10] and a large body of empirical analysis has since established that futures prices conform remarkably closely to this theoretical model.[11] For the most part those departures from randomness which have been found are consistent with the operations of scalpers who essentially perform a market-making function.

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[8] H. Working, "A Theory of Anticipatory Prices," *American Economic Review*, May 1958 pp. 188-199, reprinted in *Selected Writings of Holbrook Working*, Chicago Board of Trade, 1977.

[9] *Ibid.*, p. 39.

[10] P.A. Samuelson, "Proof that Properly Anticipated Prices Fluctuate Randomly," *Industrial Management Review*, 6, Spring 1965, pp.41-49.

At first blush the environment in which leverage contract prices are determined appear to run counter to the world of perfect competition in almost every respect. While there may be many buyers there are relatively few sellers. Buyers are typically small investors and hence may not have access to all relevant information and may lack the means to evaluate effectively the information which they do have. Prices are not determined by open outcry but rather by the leverage merchant (LTM). This scenario raises the possibility that prices may be set in an arbitrary fashion to the benefit only of the LTM.

In order to evaluate this criticism we studied both the pricing policy and practice of IPMC, a major merchant of leverage contracts in gold and silver bullion coins. The firm's bullion prices are determined in the following way.

(a) The basic price indicator is taken from the price of the dominant future traded on the Commodity Exchange of New York.

(b) This futures price is factored to a spot price equivalent. This is done in accordance with recognized economic principles, the details of which were discussed above in Section 3.

(c) The spot price so obtained is quoted as IPMC's "bid" price, the price at which they will buy back leverage contracts from clients.

(d) The IPMC "asked" price, the price at which the firm will sell leverage contracts, is calculated as the "bid" price plus 5 1/2 percent.

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[11] For example, A.B. Larson, "Measurement of a Random Process in Futures Prices," Food Research Institute Studies I, November 1960, pp.313-324; C.S. Brinegar, "A Statistical Analysis of Speculative Price Behavior," Food Research Institute Studies, IX, 1970, Supplement; R.A. Stevenson and R.M. Bear, "Commodity Futures Prices: Trends or Random Walks," Journal of Finance, 25, 1970, pp.65-81. Somewhat different results are reported by J.S. Mann and R.G. Heifner, The Distribtuion of Shortrun Commodity Price Movements, U.S. Department of Agriculture, ERS Technical Bulletin 1536, March 1976, who find a significant tendency to continuity in price. These results are most likely due to their use of individual contracts as the unit of analysis.

To the extent that this pricing policy is strictly followed many of the criticisms mentioned above are effectively rebuffed. Changes in futures prices, which are generally appropriate and prompt responses to new market information, are immediately translated into prices for leverage contracts. The 5 1/2 percent differential between bid and asked prices is a return to the merchant for his overhead and similar costs and is essentially a retail markup. In the case of leverage contracts in coins the IPMC "bid" price is equal to the current spot quotation from a leading coin dealer. Again, the asked price is calculated as the bid price plus 5 1/2 percent.

In order to provide some degree of independent verification that the above pricing mechanism is in fact generally followed, a sample of 179 leverage transaction prices (112 in silver and 67 in gold) was taken and these prices compared with spot gold and silver bullion prices quoted in New York by Handy and Harman. The Handy and Harman prices are widely accepted as authoritative indicators of spot bullion values and were taken from the yearbooks of the International Monetary Market Division of the Chicago Mercantile Exchange. Specifically the following simple regression equations were estimated

$$L_G = \underset{(1.1602)}{1.2058} + \underset{(0.005663)}{1.0518} \; H_G \quad , \; R^2 = 0.9979$$

$$L_S = \underset{(9.3783)}{12.3638} + \underset{(0.02117)}{1.0224} \; H_S \quad , \; R^2 = 0.9501$$

where

L_G, L_S are IPMC asked prices for gold and silver respectively,

H_G, H_S are Handy and Harman spot prices for gold and silver respectively.

Figures in brackets are estimates of standard errors.

These results are consistent with the pricing policy described above. The correlation is not perfect because the Handy and Harman price is essentially a "closing" price whereas the transaction might have taken place at any time during the day.

In summary the pricing procedure and the empirical results support the view that leverage contract prices for bullion are a reflection of true market prices and are not determined in an arbitrary or discriminatory fashion. Of course this conclusion refers only to IPMC and is valid for the industry as a whole only to the extent that comparable policies are followed by other firms.

5. CUSTOMER TRADING RESULTS

Yet another approach to evaluating the leverage contract as an investment medium is to study the actual trading results of clients. Additionally, it may be of interest to examine the fee structure inherent in the leverage contract and thereby to compute the extent of price movement required to produce a profit.

We estimate that a price increase of approximately 17.3 percent in the first year and 8.1 percent in each subsequent year is required for the purchaser of a leverage futures contract to break even.[12] Of course if a contract is held for two or more years it is not necessary that these figures be achieved in each year, but that an equivalent accumulative rate of price increase occur (an average of 12 percent *per annum* over two years or 10 percent *per annum* over three years, for example). These figures are based on the following calculations.

1. Charges incurred on purchase

(i) IPMC asked price = 105.5 percent of bid price

i.e. = 105.5 percent of current spot price

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[12] These figures are based on the rate structure used by IPMC.

(ii) At time of sale IPMC charges 3 1/2 percent commission on total sale (no "exit commission" is charged when a contract is closed).

(iii) Therefore total markup "at front" = 9.2 percent

2. Charges incurred on continuing basis

(i) Leverage fee of 9.875 percent on unpaid balance. Assuming an average unpaid balance of 75 percent, [13] the leverage fee represents an annual charge of 7.4 percent of the value of the commodity.

(ii) An annual service fee of 1 percent of the market value of the commodity is charged.

(iii) Therefore annual charges in addition to initial charges = 8.4 percent.

Tables 4 and 5 show the movement in gold and silver prices in recent years.

The figures in these tables are monthly average prices, hence the extent of daily price variation (and potential trading profits) is significantly understated. Yet even from these figures it can be seen that price variability is such that purchases of leverage contracts can be profitable given good judgement of future price movements.

Having established that it is feasible for a customer to profit from leverage contract transactions we turn our attention to the extent to which such transactions have in practice resulted in profits. Early in 1978, as part of an industry wide CFTC survey into "retail leverage-type transactions," the Commission's Division of Enforcement collected data on more than 700 individual accounts held by clients of IPMC. For purposes of analysis we discarded approximately 80

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[13] Unpaid balances represented 74.2% and 76.5% of liability to customers for metals valued at quoted market prices as of December 31, 1977 and 1976 respectively. These figures were obtained from IPMC Notes to Financial Statements for year ended December 31, 1977 and 1976 (p.10).

Table 4

Monthly Average Spot Price of Silver Bullion, New York (c/oz)[a]

	1973	1974	1975	1976	1977	1978
Jan	201.7	363.7	419.3	406.3	440.9	493.7
Feb	223.6	535.9	437.0	408.6	452.7	494.8
Mar	230.9	532.6	434.5	418.9	483.9	523.4
Apr	220.7	503.6	420.9	435.1	478.3	511.9
May	240.1	543.2	453.8	448.9	469.2	509.7
Jun	262.1	489.6	448.9	481.2	444.2	
Jul	270.6	441.6	[illegible]0.5	478.0	449.8	
Aug	263.7	443.1	492.5	423.7	443.9	
Sep	267.5	404.9	451.6	429.5	453.9	
Oct	288.6	483.0	432.9	442.5	475.7	
Nov	286.0	469.4	433.2	437.2	483.1	
Dec	313.7	439.1	408.5	434.7	470.4	
Price Increase During Year	+55.5%	+20.7%	-2.6%	+7.0%	+6.7%	+3.2%[b]
Maximum Price Increase from Low to Subsequent High	+55.5%	+49.4%	+17.5%	+18.4%	+9.8%	+6.0%[b]

Notes:

a/ Source Jan 1973-Feb 1977, 1977 Commodity Yearbook; March 1977 - May 1978, Wall Street Journal.

b/ Refers to Jan-May only.

Table 5

Monthly Average Spot Price, Gold Bullion, New York ($/oz)[a]

	1975	1976	1977	1978
Jan	176.8	132.0	132.9	173.8
Feb	180.0	131.6	136.4	178.7
Mar	178.6	133.1	148.7	183.2
Apr	170.3	128.4	149.8	175.5
May	167.9	127.4	147.2	175.6
Jun	164.7	126.4	141.6	
Jul	165.7	118.0	144.0	
Aug	163.5	110.1	145.5	
Sep	144.1	114.7	150.6	
Oct	143.3	116.6	159.2	
Nov	143.3	131.4	162.9	
Dec	139.8	134.4	161.1	
Price Increase During Year	-20.9%	+1.8%	+21.2%	+1.0%[b]
Maximum Price Increase from Low to Subsequent High	+1.8%	+22.0%	+22.6%	+5.4%[b]

Notes:

(a) Source, Jan 1975-Jan 1977, 1977 Commodity Yearbook; Feb 1977-May 1978, Wall Street Journal.

(b) Refers to Jan-May only.

accounts involving transactions in copper, as IPMC no longer offers leverage contracts in copper, leaving 619 accounts. Of these, 189 accounts were active as at the survey date (March 8, 1978) and 430 were closed accounts.

In order to compute the profitability of these accounts all relevant fees were levied against active accounts. When this was done 32.5 percent of all accounts were profitable, while 67.5 percent resulted in a loss. A significant difference was found between active accounts and those which had been closed. 61.9 percent of active accounts were profitable while only 19.5 percent of closed accounts showed a gain. Full details are shown in Table 6.

This analysis suggests that purchasing a leverage contract is generally a poor investment. However it is important to realize that the above results are quite consistent with studies of the results of commodity investments by small traders generally and are not peculiar to investment in leverage contracts.

So far as we can determine three studies of distribution of profits based on recorded trading results have appeared in the literature. The earliest of these was undertaken by Stewart [14/] who analyzed the complete trading records of 8,922 customers of a large Chicago commission firm over the nine-year period 1924-32. He found that only 2,184 (24.5 percent) of the customers' accounts yielded a profit. A more detailed analysis by commodity is provided in Table 7. In discussing these results some years ago the present authors [15/] noted:

> This dismal record is ameliorated by two major considerations: (1) the commission firm went bankrupt, suggesting that traders dealing through other commission firms may have had better success, and (2) the period was one of net price decline, and a disproportionate share of the losses were incurred during the last 3 years, when prices declined sharply, whereas the sample of traders was mainly on the long side. It is perhaps too much to expect avocational commodity specula-

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[14/] Blair Stewart, An Analysis of Speculative Trading in Grain Futures, Washington, D.C., U.S.D.A. Technical Bulletin No. 1001, October 1949.

[15/] Roger W. Gray and David J.S. Rutledge, "The Economics of Commodity Futures Markets: A Survey," Review of Marketing and Agricultural Economics, Vol. 39, No. 4, December 1971 (Sydney, NSW, Australia), p. 24.

Table 6

Summary of IPMC Profit/Loss Survey

Commodity	Profit Accounts	Loss Accounts	Total
Gold Bullion	36	63	99
Silver Bullion	85	287	372
Krugerrands	59	35	94
Sovereigns	13	18	31
Clads	3	11	14
Double Eagles	5	1	6
90% Silver	--	2	2
Mexican 50 Pesos	--	1	1
TOTAL	201	418	619

Table 7

Summary of Results of Stewart Study *

	Profit traders			Loss traders		
Commodity	Number	Total net profits	Average profit per trader	Number	Total net losses	Average loss per trader
Wheat	2,045	$1,508,407	$738	5,496	$ 9,411,620	$1,712
Corn	1,525	$1,183,993	$776	2,403	$ 2,222,602	$ 925
Oats	589	$ 124,038	$211	997	$ 772,132	$ 774
Rye	497	$ 293,042	$590	816	$ 825,838	$1,012
All grains[a]	2,184	$2,064,800	$945	6,598	$11,958,200	$1,812

* Blair Stewart, An Analysis of Speculative Trading and Grain Futures, p.57.

a/ The "all grains" figures are not equal to the totals of the figures for individual grains because some traders made profits in one or more grains but lost on their futures transactions in one or more of the other grains.

> tors to forecast a severe slump in general economic conditions. It is unfortunate, to say the least, that this is the only published record of trading results for any substantial group of traders over any extended time period.

In the period since that was written two further studies of commodity trading records have appeared. The first of these is reported in Professor T.A. Hieronymus' well known textbook [16/] and is based on records of closed trades for a commission house for the calendar year 1969. The results are reported in detail in Table 8, but their most salient feature is that 35 percent of the firm's customers recorded a profit (and 65 percent recorded a loss). Commodity prices in 1969 fluctuated moderately without exhibiting any marked trend.

Even more recent is a study by R.L. Ross, [17/] in which a cohort of customer accounts established in 1967 and 1968 was followed over a five-year period. The results are summarized in Table 9, but again the major finding is clear--of 380 traders covered in the survey 242, or 63.7 percent, recorded losses. Over the period covered by the Ross study commodity prices fluctuated considerably but without any obvious trend in aggregate.

The studies reported by Hieronymus and Ross suggest that the tendency for small speculators to lose money is perhaps more pervasive than we believed in 1970.

Nevertheless the analysis does show that the trading results obtained by leverage customers of IPMC do not appear to differ significantly from those of small traders in commodities generally. There is no evidence of any interest

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[16/] T.A. Hieronymus, Economics of Futures Trading, Commodity Research Bureau Inc., New York, 1971.

[17/] Ray L. Ross, "Financial Consequences of Trading Commodity Futures Contracts," Illinois Agricultural Economics, July 1975, pp.27-31.

Table 8

Summary of Results of Hieronymus Study*

Number of accounts	462
Number of accounts with profits	164
Total profits (dollars)	$462,413
Profit per account (dollars)	$2,819
Number of accounts with losses	298
Total losses (dollars)	$1,127,355
Losses per account (dollars)	$3,783
Average result (loss) (dollars)	$1,439
Net Loss, all accounts (dollars)	$664,942
Commissions paid (dollars)	$406,344
Put to clearing house (dollars)	$258,598

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* Thomas A. Hieronymus, Economics of Futures Trading, Commodity Research Bureau, New York, 1971, p. 253.

Table 9

Summary of Results of Ross Study*

	Profit-makers			Losers			
Years of trading	Number	Total	Average profit	Number	Total	Average Loss	Net loss of all traders
			(Dollars)				
One	70	40,153	574	124	252,135	2,033	211,982
Two	35	49,161	1,405	80	473,363	5,917	424,202
Three	19	147,693	7,772	24	163,768	6,828	16,075
Four	13	317,041	24,388	13	328,678	25,283	11,637
Five	1	2,399	2,399	1	9,381	9,381	6,982
Total	138	556,447		242	1,227,325		670,878
Average			4,032			5,030	

* Ray L. Ross, "Financial Consequences of Trading Commodity Futures Contracts," Illinois Agricultural Economics, July 1975, Table 4, p.30.

characteristic in the leverage contract which preordains an unusual tendency towards trading losses.

If this is so, the trading losses must be attributed to errors of judgment on the part of individual traders. That this is indeed the case is strongly suggested by the following additional analysis of the IPMC survey accounts. Suppose that the 430 accounts which were closed prior to March 8, 1978 had not been closed, but had been held open until March 8. After all leverage and service costs have been accounted for, 229 (53.3 percent) of these accounts would have shown a profit. Many unprofitable accounts would have earned profits had they not been closed.

Further evidence, if it is required, of the difficulties facing the small trader in forecasting commodity prices is provided in a study by Rockwell.[18] Rockwell's analysis involved computing hypothetical trading results for highly aggregated classes of futures traders, among them "small traders" who are probably mainly speculators. His results show small traders approximately breaking even, but more important for present purposes, the analysis shows that these traders exhibit no ability as a group to forecast commodity prices.

Another perspective on trading results is gained by comparing investment in gold and silver via a leverage contract with returns which would have been earned in alternative investments. We have already noted the tendency for prices of precious metals to move counter-cyclically with the stock market. Over the period covered by Tables 4 and 5 the stock market has not performed well from the point of view of the small investor. This fact assumes added significance in light of the trading results of those IPMC accounts which remained open at the time of the CFTC survey. It is amongst these accounts that we would most expect to find individuals trading in precious metals as a long term hedge against inflation and it is precisely these accounts which have recorded the best results.

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[18] Charles S. Rockwell, "Normal Backwardation, Forecasting, and the Returns to Commodity Futures Traders," Food Research Institute Studies, VII, Supplement, 1967, reprinted in A.E. Peck, ed., Selected Writings on Futures Markets, II, Chicago Board of Trade, 1977.

By way of conclusion we would argue that analysis of trading results, while of considerable interest, cannot be used to infer that there is an inherent bias towards losses in the leverage contract. Provided that the customer is given full information about the rate structure (as IPMC's customers are), and hence can calculate the price increase required to produce a profit, we are of the opinion that no such bias exists. When prices rise persistently holders of leverage contracts will make profits and one must assume that purchase of the contract was predicated on the expectation of such a price rise. If the expected price movement does not occur the holder of the contract will incur a loss, but this loss is a reflection of an incorrect judgment as to price.

6. HEDGING POLICY AND PRACTICE

The Subcommittee on Futures, Forward and Leverage Contracts of the CFTC Advisory Committee on Market Instruments included in its deliberations a study of the question of coverage of leverage transactions. On this subject it recommended as follows.

> "There must be 100% coverage of all Section 217 transactions. Permissible coverage may be a Commission determined combination of futures, forwards and actuals. This should be qualified, however, by the following rules:
> (A) A gold obligation cannot be covered in silver and vice versa;
> (B) A bullion obligation can be covered in bullion and/or coin (with appropriate regard for the bullion content of the coin); and
> (C) A coin obligation can be covered in coin but not in bullion." 19/

19/ CFTC Advisory Committee on Market Instruments, Recommendations of Subcommittee on Futures, Forward and Leverage Contracts, pp. 11-12. Three members of the Subcommittee dissented from the recommendation that forward contracts should be a form of permissible coverage.

The basis for this recommendation is that if the LTM is permitted to sell "naked" leverage contracts there can be no guarantee that he will be able to fulfill his obligations in the event that the customer makes all required payments and demands delivery. Moreover, as we have noted earlier, the LTM who holds little or no cover is highly vulnerable to adverse price movements and consequently is likely to fail, causing losses to all his clients with open positions. There can be little doubt that many of the difficulties associated with the commodity options industry arise from the practices of selling "naked" options.

On the basis of information supplied to us by IPMC we are satisfied that its hedging policy is consistent with the spirit of the Advisory Committee's recommendations. Figures included in the Notes to IPMC's Financial Statements (audited by Coopers and Lybrand) show that long positions in futures, forwards and actuals as at December 31, 1975 and December 31, 1977 were more than sufficient to cover quantities due to customers in all commodities.

We have also examined IPMC's hedge position in gold and silver bullion at monthly intervals from September 1975 to April 1978. In the case of these commodities coverage is held exclusively in futures and actuals, thereby meeting the concern of three members of the Subcommittee who believed that forward contracts should not be a form of permissible coverage. In general coverage via futures contracts accounted for approximately 75 to 85 percent of total long position held by IPMC in gold and silver bullion, with the remainder being physical inventory. As far as we can judge, such variation in these proportions as has occurred over time has been consistent with normal business practice involving the management of spot and futures positions.

In the case of bulk coins, where active futures markets are not available, IPMC's hedge position is held jointly in actuals and forward cash commitments.

We note in conclusion that the ability of the LTM to fulfill his delivery obligations is assured only by coverage in actuals. Experience to date suggests that less than ten percent of leverage contracts are closed out by delivery[20/] so that this is unlikely to be a problem in practice. On the other hand, coverage in futures and forward contracts generally provides adequate cover against adverse price movement.

7. COMPLIANCE AND RELATED ISSUES

As noted earlier in this study, the CFTC, although empowered to do so, had not taken steps to regulate leverage transactions in gold and silver. Nevertheless it is possible to compare present industry procedures with the regulatory framework recommended by the CFTC Advisory Committee. In addition to those discussed elsewhere in this study, the important features of these recommendations, designed to ensure an acceptable degree of customer protection, were as follows:

(a) Registration of LTM's;

(b) Minimum financial requirements of LTM's;

(c) Segregation of customer funds;

(d) Establishment of requirements for advertising and promotional material;

(e) Requirements with respect to financial reporting;

(f) Disclosure requirements;

(g) Know-your-customer rules.

We have studied the financial reports and the operations of the Compliance and Customer Relations Division of IPMC and are of the opinion that they conform

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20/ CFTC, Press Release, April 27, 1978, p.2.

Table 10

Summary of IPMC Leverage Customer Inquiries/Complaints During 1975-1977

Year	Number of Inquiries/ Complaints	Action by Customers	Resolution
1975	2	Inquiries to IPMC	Resolved in-house*
	1	CFTC reparations complaint	Settled
1976	15	Inquiries to IPMC	Resolved in-house*
	1	Inquiry to IPMC	Withdrawn by customer
	1	Inquiry to IPMC and state authorities	Withdrawn by customer
	2	Inquiries to IPMC and state authorities	Inquiries answered, no further action by state authorities
	2	Inquiries to CFTC, referred to IPMC	Inquiries answered, no further action by CFTC
	1	Action filed in state court	Settled
	1	CFTC reparations complaint	Settled
1977	14	Inquiries to IPMC	Resolved in-house*
	5	Inquiries to IPMC	Withdrawn by customer
	1	Inquiry to IPMC	Resolution pending
	1	Inquiry to state authority, referred to IPMC	Inquiry answered, no further action by state authorities
	1	Inquiry to state authority, referred to IPMC	Settled
	1	Inquiry to CFTC, referred to IPMC	Settled
	1	CFTC reparations complaint	Dismissed by CFTC - Divisi of Enforcement
	1	CFTC reparations complaint	Settled
	1	CFTC reparations complaint	Pending (as of May 26,1978)

*Note:

The term "resolved in-house" refers to inquiries resolved through either (a) an explanation to the customers' satisfaction, after which the complaint was withdrawn or no further action taken by the customer; or (b) a mutually agreeable monetary settlement between IPMC and the customer.

with the spirit of the proposed regulations.

A very crude, but nevertheless interesting, measure of the extent of this conformity is obtained by examining IPMC's records concerning customer inquiries and complaints. In the period 1975-1977 (inclusive) a total of 52 inquiries or complaints were received by IPMC, state authorities or the CFTC. Of these 42 were resolved by mutual agreement between the customer and IPMC, withdrawn by the customer, or answered by IPMC with no further action taken. Only 7 cases involved litigation or formal docketing as a complaint in a CFTC reparations proceeding. Further details are provided in Table 10.

While these figures are of some general interest it is impossible to draw any definitive conclusion from them and we do not intend to do so. However, they do allow us to suggest, with caution, that the extent of customer dissatisfaction with IPMC's leverage operations is not great and not disproportionate when compared to other similar industries such as the futures industry. Some support for this view can be derived from the fact that the CFTC Annual Report for 1977 makes no mention of complaints or litigation relating to leverage contracts. This is all the more surprising in light of the regulatory vacuum within which the industry is presently operating. Presumably the extent of customer dissatisfaction would diminish following the introduction of a satisfactory set of regulations.

8. Definitional Issues

The foregoing sections of this study have described and analyzed the leverage contract, particularly as it is written and marketed by IPMC. This has necessarily entailed some comparisons to other instruments or investments, but it has not adduced the full extent to which leverage contracts have been confused with some alternatives in the regulatory environment. In this section we propose to address this confusion, with special reference to the question whether a leverage contract may be said to be a futures contract.

There exists no statutory definition of a leverage contract, nor for that matter of a futures contract, nor are such definitions proposed here. Instead we proposed to address the issue as one of clear distinctions which must be made and held. There are inumerable instances in commodity law in which terms that are employed are not explicitly and categorically defined, but where instead reference must be had to "commonly understood" meanings arising out of business practice and case law determinations. One reason for this is that any effort to define such terms rigorously and exhaustively would soon invite slignt variants in practice which could provide exclusions; whereas on the other hand broader definitions may be inclusive of fundamental differences among concepts.

The advisory task force on market instruments undertook to characterize leverage and other commodity contracts according to an extensive list of descriptive elements, thereby providing a useful taxonomy, but failing at the same time to focus upon the economic role or function of each particular instrument. The CFTC has subsequently become so preoccupied with the options problem that it has been tempted to play with definitions in order to avert the recurrence of that problem in whatever form. Having been empowered to ban the sale of commodity options, but not leverage contracts, and having proceeded to invoke its powers against certain forms of options trading which it found fraudulent or abusive, the CFTC has now perceived that some firms that are proscribed from selling options are entering the leverage contract business. Their frustrations and apprehensions are understandable. The options trading which led to the original (1936) ban against trading options in defined "commodities" was of a markedly different character from the options trading which led to the debacle of the early 1970s. The former comprised chiefly "overnight" puts and calls and was engaged in mainly by commercials and professionals. The latter (a la Goldstein-Samuelson) entailed the retail sale to the public of options on non-regulated commodities (not defined in the 1936 act as amended prior to 1974). Clearly the Goldstein-Samuelson fiasco was the outgrowth of a loophole (unregulated commodities); but no sooner was that loophole plugged than another (London options) was revealed, and soon exploited. Moreover, the two experiences of the 1970s revealed two opposite extremes at which options may be said to be "inherently fraudulent" (1) the options may be priced so cheaply that there is no reasonable probability that the options writer can pay off—hence a Ponzi scheme, or (2) the options may be priced so dearly that there is no reasonable prospect that the customer can make money. In between these extremes, and short of "inherent fraud," lie a range of possibilities for misrepresentation, "boiler room" sales tactics, and the like. That the CFTC should seek to assure competitive pricing by confining options trading to exchanges in these circumstances is not surprising, notwithstanding the fact that a limited exemption has already been posted to this neat solution.

By extension of their options experience, the CFTC might have been expected at this point to argue that a leverage contract is not significantly different from an option contract, especially as both are marketed at retail at prices established by the seller (which similarities have not passed unnoticed by firms formerly marketing London options). This argument would have to confront the statutory distinction, however, as well as some obvious mechanical distinctions. This easy choice was denied CFTC by virtue of the fact that they were empowered to ban options trading directly, if they chose, but if they were to effectively prohibit leverage transactions it would have to be by indirection.

Two indirect avenues which they have explored, and which would effectively ban leverage contracts as presently marketed, are (1) yielding up leverage contract regulation to the SEC, or to state agencies, by implicitly defining them to be securities, and (2) defining leverage contracts to be futures contracts. The first of these proposals to "define away the problem" can be disposed of quite briefly; the second and presumably more viable alternative (in CFTC's view) needs more careful consideration.

Defining Leverage Contracts to be Securities

The CFTC has been understandably defensive of its jurisdiction over futures trading in securities, such as GNMA mortgage backed securities and treasury bills. This posture provides a backdrop against which any suggestions that SEC should regulate leverage contracts appears bizarre. Competent authorities may disagree as to whether a futures contract in a security is itself a security (we think it is not); but there is not disagreement so far as we know that a commodity contract is not a security. [21] The courts have so held consistently, and in particular as to leverage contracts. Thus for CFTC to abdicate its regulatory role over leverage contracts in favor of SEC really implies one of two outcomes: (1) SEC would correctly construe it that these are not securities, and leave them unregulated, or (2) SEC would incorrectly construe it that they are securities, invoke regulation "T" margin requirements, and put existing firms out of business. The first outcome is inconsistent with CFTC fears that there may be serious real or potential problems in the leverage industry. The second outcome is to accomplish by twisting words what they are reluctant to do by twisting the sword.

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[21] See, for example, A. Bromberg "Commodities Law and Securities Law--Overlaps and Preemptions," The Journal of Corporation Law, 1, 2 (1976) p.234.

Defining Leverage Contracts to be Futures Contracts

More recently the CFTC appears to have been leaning, not to say straining, toward the interpretation that a leverage contract is, in all but name or unimportant particular, really a futures contract after all. This line of semantics carries the interesting implication that, since the leading "unimportant particular" in which leverage and futures contracts differ is that the latter are traded on organized exchanges with clearing mechanisms, leverage contracts should be required to be so traded. Given the existence of very active futures markets for gold and silver, existing leverage transactions would simply disappear under this requirement, thereby proving that they never really existed!

The acting chief economist of the CFTC, in his memorandum to the commission dated May 8, 1968, has concluded that most leverage contracts are "essentially futures contracts." The major difference between leverage and futures contracts—the fact that leverage contracts are retail extensions of futures contracts and are priced and sold differently (off exchanges)—is brushed aside as an irrelevancy. "Once it is granted that the off-exchange nature of leverage contracts is not germane to the determination of whether or not they are futures contracts" it is asserted (p. 4), "many of the 'distinguishing characteristics' become irrelevant." As with many a syllogism, the trick is to slip the major premise through. But it cannot be "granted that the off-exchange nature of leverage contracts is not germane..." Leverage contracts are designed for, and evidently appeal to, a different clientele from those who trade futures. In particular, they are predominantly longer term contracts and they are marketed in smaller units. The memorandum from the acting chief economist to the CFTC attempts, without success, to belittle these distinctions. By citing sample evidence that contracts of nominal five or ten year duration are held open on average for less than a year, the chief economist would have us believe that this is comparable to futures. We are not provided, however, with any evidence regarding the average holding period of small futures speculations, which would almost certainly be less than a month. As a matter of fact, IPMC contracts have had an average duration of just under a year for closed contracts, whereas those remaining open had been open for a year on average. Secondly, we are told that futures exchanges attempt to curry public favor by promulgating smaller contracts than the commerical trade might prefer, and that the Midamerica Commodity Exchange actually specializes in smaller futures contracts. But we are not given the additional facts that leverage contracts are smaller still, and that most customers purchase only one contract. Nor are we told that fractional leverage contracts are available to the customers who already have one contract. In short, while leverage contracts are extensions of futures in two dimensions that futures exchanges have not seen fit to match, this aspect is glossed over in the memorandum by the acting chief economist. One dimension is the size of contract, which is significantly smaller--the other is duration, which is significantly longer.

To consign this distinct market to the futures exchanges would not only have the effect of putting reputable firms out of business, but would probably have the effect of consigning this distinct market to oblivion. Futures exchanges have displayed no interest in contracts of this size or duration. When the Comex, for example, went twenty-three months out with its silver futures contract, it was done to accomodate certain sophisticated tax-spreads--not at all in order to reach the small investor. The basic reason why futures exchanges do not promulgate long term or retail size contracts is that they do not perceive sufficiently large trading volume to justify them--and the prospect of very thin trading in such contracts poses two related problems: (1) prices become less reliable and trading costs rise; and (2) CFTC might well revoke designation of such contracts. In effect, this could bring matters full circle. The CFTC, by forcing this market onto futures exchanges, could find either that exchanges don't want it or that they would be unable to service it to CFTC satisfaction.

Further in regard to contract duration, the memorandum to the CFTC ignores the point that contracts written for distant delivery dates must be priced as though they are to be held to such date, irrespective of whether many are offset earlier. In the case of futures contracts, for raw materials commodities, the low liquidity and greater risk attaching to distant months typically means that the seller must accept a discount. The reason for this has been that hedge sales have predominated over hedge purchases, and speculators have been willing to buy distant futures only at discounts. Gold and silver, however, are commodities reflecting a store of value, and to the extent that there is any great hedging interest in them it is as a hedge against inflation. This means that such "hedgers" are buyers, and hence that speculators who would contract with them need to be sellers, hence that more distant futures must be priced at a premium. A similar phenomenon is reflected in the normal term structure of interest rates, which finds long-term rates higher than short-term rates. "Liquidity preference" is for money over goods in the short term--but for many people in an inflationary environment it is distinctly for gold or silver over money in the longer term. Thus a contract which calls for the exchange of gold or silver for money five or ten years in the future must relate to long term interest rates and must entail higher carrying costs than a nearby futures contract. The buyer of a leverage contract has the alternative (if he wishes to deal in sufficiently large quantities, of owning nearby futures and rolling these forward as long as he wants to hold. What he would save owing to smaller contangos and greater liquidity in nearby futures he would probably give back in commissions on a series of transactions.

As an example, on May 31, 1978, the nearby June-September spread in silver futures on the Chicago Board of Trade was under eight cents per ounce whereas the 1979 June-September spread was 10 1/2 cents per ounce (settling prices). This difference reflects the larger contango on distant futures; but it does not reflect the possible higher cost of obtaining a purchase a year out.

In light of the above considerations it is our conclusion that leverage contracts provide a distinctive retail package which is not available on the futures exchanges. Leverage contract dealers can manage a hedging program with greater expertise and at lower costs as compared to their customers, and as with any retail operation customer convenience would be expected to entail a price. The "retail mark-up" would include reasonable sales commissions, service charges, and of course the carrying charges (inventory costs) incurred by the retailer. Obviously in the absence of competition or sufficient customer information, such a retail mark-up could be exorbitant; but from our examination of the records and practices of IPMC we conclude that their leverage contracts are reasonably priced.

Other Definitional Escapes

If the CFTC chooses to play "blind men and elephant" as it gropes toward escaping its regulatory responsibilities, the aforementioned alternatives do not exhaust the possibilities. There are at least as many possibilities as there are commissioners. One can grasp the leverage contract where it most resembles an option contract, another can grasp it where it most resembles a security, another where it most resembles a futures contract--still another, if he so chose, could declare that IPMC is an exchange; leaving it to the last commissioner to assert that IPMC is a "bucket shop." (We offer these suggestions satirically in full view of the possibility that they might be taken seriously.)

But an elephant is neither a wall, nor a spear, nor a snake, nor a tree, nor a fan, nor a rope--nor really anything else than an elephant. A leverage contract is a leverage contract--clearly distinguishable from other forms of commodity trading or investment—and should be regulated accordingly.

9. CONCLUSIONS

The major conclusions of this study have already been stated in each section. Brought together they can be summarized as follows:

(a) The leverage contract in gold and silver is a potentially useful investment tool for the general public. At the same time it is a financial instrument which differs in several substantive respects from other forms of forward contracts such as the futures contract.

(b) The process of price determination followed by IPMC is not arbitrary. Rather leverage contract prices are tied to futures prices in a natural way so that all the positive attributes of futures prices are transmitted to leverage contract prices.

(c) The "leverage fee" or "carrying charge" expense incurred by purchasers of leverage contracts is not a fictitious fee but is based on sound economic and business principles.

(d) The trading results of leverage contract customers, based on a sample of IPMC accounts, are very similar to results obtained by small commodity traders in general. There appears to be no significant tendency for leverage account customers to incur trading losses when compared to other forms of commodity investment.

(e) The policies and practices of IPMC regarding coverage of client positions, segregation of customer accounts and compliance matters generally, are in accord with the regulatory framework for the industry which was recommended by the CFTC Advisory Committee on Market Instruments.

STATEMENT OF STEVEN M. WILSON, COMMODITY CONSULTANT, EVERGREEN, CO.

Commodity Futures trading has grown dramatically in the past fifteen years. The surge in new contracts have broadened the economic base of this industry. The price - discovery mechanisms when operating properly in a commodities futures market can provide producers and processors with an effective risk management system.

In our global economic community, the commodity futures markets will continue to grow and expand as they should. The commodity futures markets are a must.

The regulation of these markets has never been, nor will it ever be a simple task. Whenever you have large amounts of money changing hands quickly you will inevitably attract a certain percentage of individuals and firms willing to commit fraud. This fact of life is by no means limited to the commodity futures industry. But the commodity industry is one of the least regulated in the Western world. This fact makes the attraction to this industry even more sweet to those persons or firms seeking to profit by defrauding the public.

A few of these brokerage houses are literally built upon deception, bricked in fraud and mortared in perfidy. Masters of trickery and deceipt, they solicit customers who they regard as nothing more than sheep. They encourage them to try their hand in the fast paced, ever-promising commodity markets. They invite these sheep to do so through their house. Displayed as a house of economic opportunity, the unsuspecting sheep enter the doors often willingly accepting the risks facing them in the market, but never suspecting the evils which await them inside the house. The customer agreements are signed and the doors close behind them. The sheep are now locked inside not the house of economic opportunity but rather inside the house of shears.

How the sheep will be sheared depends on which door the wolf broker shepherds them through. The methods of fleecing are numerous.

Most sheep never realize what happened. Like one eighty year old gentleman from Nebraska who was defrauded. He left his wife a note, loaded his twelve gauge shotgun, placed the barrel in his mouth and pulled the trigger.

Those customers who feel they were wronged and seek to remedy the situation frequently discover after the fact through their attorney that there are only three avenues available to them. They discover that when they opened their account they also signed a "Consent To Jurisdiction" clause next to a spot marked X. This clause forces the customer to bring his action in Cook County, Illinois, to hire a Chicago lawyer, to suffer inordinate expense and wait five years in the Court backlogs of Chicago.

Brokerage houses who insist on customers signing "Consent To Jurisdiction" clauses should advertise, mass mail and cold call only to residents within that designated jurisdiction. But if they solicit outside that jurisdiction then let the actions be brought in the hills of South Dakota and in the farmlands of Iowa. Afterall, when David faced Goliath he did so in the land of Judah near the town of Shochoh. He faced Goliath on his own home turf. David didn't have to trek all the way to Cook County, Illinois.

The next available avenue which the customer discovers he has agreed to is Arbitration. Arbitration has its place and can be a very effective method of resolving disputes. But never in disputes involving fraud. There is little or no discovery permitted in Arbitration. So fraud can never be fully discovered or exposed. Arbitration should be consented to only after the dispute arises and never forced upon a defrauded customer.

The third avenue available for remedy is through reparations at the C.F.T.C. Here the action will be heard by knowledgeable administrative law judges. This too can be an effective method of resolving disputes. But like Arbitration the most a dishonest broker or his firm will be made to do is to give the customer his money back. But more importantly like Arbitration, there is little or no discovery in reparations. Thus not only is an ongoing fraud not exposed, it remains camouflaged and allowed to continue.

If you have a cookie thief who has stolen fifty cookies and you catch him stealing one cookie and the greatest punishment he faces is to return the one cookie, the cookie thief has profited by forty-nine cookies. He knows his downside risk is limited and a new business soon flourishes. It's called the cookie stealing business.

Arbitration like reparations must not be allowed to become an industry Stop Loss order on fraud liability.

For five hundred years, Anglo-Saxon jurisprudence has relied on the collective wisdom of a jury to determine issues ranging from guilt or innocence in capital cases to complex anti-trust matters. Why are some of the members of this industry so afraid of having their conduct scrutinized by that same system? I can think of only one reason and that is that they are afraid that juries express the consciousness of the community and they are afraid that their conduct cannot withstand that scrutiny. To avoid this scrutiny, the industry is trying to create a system which will insulate them and allow them to thumb their noses at the laws which everyone else must adhere to. Adhering to good trading principles they seek to limit their losses. They don't want to face a limit down move in a courtroom.

One result of this unique system is an arrogance that extends to some of the highest levels of the industry. In the matter of Glen Hill vs. Bache tried in Federal Court in Denver, Colorado in March of 1984, the Defendant Bache retained John Frederic Troelstrup to testify as its expert witness. Mr. Troelstrup was former Regional Counsel for the Division of Enforcement at the C.F.T.C. After which he became Executive Vice President in charge of Law and Compliance at the Chicago Mercantile Exchange. As the former head of Law and Compliance, Mr. Troelstrup testified under oath in Federal Court that commodity brokers did not have to follow a particular law. After receiving a swift admonishment from Federal Judge James Carrigan, the judge said to the jury and I quote, "I am going to instruct the jury to disregard any opinion this witness has given as to what the law is in this case. It's the obligation of the judge in a case to instruct on the law, and there is no such rule that anybody can disregard the law. Not in this country. I will instruct on that, if I am requested. But if you have gotten the impression that there is a right by anybody in this country to disregard the law, whether it's passed by Congress in a statute or by regulatory agency which has the force of law and its regulations, nobody has got the right to disregard that." A copy of part of Mr. Troelstrup's testimony is attached to my prepared text for your examination.

If Mr. Troelstrup believed that brokers don't have to follow the law, are we to expect the brokers to hold themselves to a higher standard of compliance than this industry giant? I think not.

I have never met a customer who understood the ramifications or the clauses themselves that have been discussed in this text. The question is not "What person would sign away their rights?" but rather the question is, "What type of people would insist that you sign away your rights before your account is opened?"

Effective legislation is needed to insure that consents to jurisdiction and Arbitration be consented to after the dispute arises. If not, cookie stealing will become too tempting and encourage others to do the same.

(Attachment is held in the committee files.)

STATEMENT OF

THE LONDON COMMODITY EXCHANGE COMPANY LIMITED
THE METAL MARKET AND EXCHANGE COMPANY LIMITED
THE LONDON INTERNATIONAL FINANCIAL FUTURES EXCHANGE LIMITED
THE GRAIN AND FEED TRADE ASSOCIATION
AND
INTERNATIONAL COMMODITIES CLEARING HOUSE LIMITED

BEFORE THE

SUBCOMMITTEE ON CONSERVATION, CREDIT, AND RURAL DEVELOPMENT
OF THE
HOUSE OF REPRESENTATIVES COMMITTEE ON AGRICULTURE

MARCH 19, 1986

This testimony is being submitted by the law firm of Arnold & Porter, 1200 New Hampshire Avenue, N.W., Washington, D.C. 20036, on behalf of its clients, the London Commodity Exchange Company Limited, Cereal House, 58 Mark Lane, London EC3R 7NE, England; the Metal Market and Exchange Company Limited, Plantation House, Fenchurch Street, London EC3M 3AP, England; the London International Financial Futures Exchange Limited, Royal Exchange London EC3V 3PJ, England; the Grain and Feed Trade Association, 24 Saint Mary Axe, London EC3, England; and International Commodities Clearing House Limited, Roman Wall House, 1-2 Crutched Friars, London EC3N 2AN, England. Since these companies are foreign organizations, Arnold & Porter is registered with the Department of Justice under the provisions of 22 U.S.C. § 611, *et seq.*, as their agent. Copies of this testimony are being filed with the Department of Justice, and copies of Arnold & Porter's registration statement are available for public inspection at the Department of Justice. Registration does not indicate approval of this material by the United States Government.

I. INTRODUCTION

My name is Brooksley Born. I am a member of the Washington, D.C. law firm of Arnold & Porter, and I am submitting this statement on behalf of the London Commodity Exchange Limited, the Metal Market and Exchange Company Limited, the London International Financial Futures Exchange Limited, the Grain and Feed Trade Association, and the International Commodities Clearing House Limited (hereinafter the "Exchanges").[1]

A. THE LONDON COMMODITY EXCHANGE COMPANY LIMITED

The London Commodity Exchange Company Limited ("LCE") represents the interests of its member associations, which are:

(1) The London Sugar Futures Market Limited (formerly the United Terminal Sugar Market Association Limited);

(2) The Coffee Terminal Market Association of London Limited;

(3) The London Cocoa Terminal Market Association Limited;

(4) The London Rubber Terminal Market Association Limited; and

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[1] These collective views of the Exchanges are subject to appropriate supplement by separate views of an individual exchange.

(5) The International Petroleum Exchange of London Limited.

These LCE associations operate the London futures markets for sugar, coffee, cocoa, rubber, and petroleum products. The membership of the LCE associations includes a large number of companies established in many different parts of the world involved in worldwide trading in commodities. Many are U.S. futures commission merchants ("FCMs") who accept orders in the United States for futures transactions on the LCE.

LCE's markets have a long history of stable and successful trading and self-regulation. LCE enjoys a high international reputation and has operated for many years.

B. THE METAL MARKET AND EXCHANGE COMPANY LIMITED (THE LONDON METAL EXCHANGE)

The London Metal Exchange ("LME") has been in existence for well over 100 years. It is the world's most comprehensive metal market and handles the trading of seven metals -- copper, tin,[2] lead, zinc, silver, aluminium, and nickel.

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[2] Tin trading is currently subject to indefinite suspension.

LME trades on a principal-to-principal basis among its members. It is regulated internally by a committee annually elected by the membership.

LME is an international market. More than three-quarters of its ring-dealing companies are affiliates of non-U.K. firms, many of which are U.S. corporations. LME's official daily metal prices are disseminated worldwide and form a basis for contractual prices between producers and consumers for most of the metals traded throughout the Western world outside the dollar areas, as well as in the Eastern bloc.

C. THE LONDON INTERNATIONAL FINANCIAL FUTURES EXCHANGE LIMITED

The London International Financial Futures Exchange Limited ("LIFFE") is an independent London exchange which commenced operations in 1982. LIFFE provides facilities for trading in futures and options contracts covering interest rates, currencies, and the FT-SE (Financial Times-Stock Exchange) 100 Index. The primary supervision of LIFFE and its members is the responsibility of its board, which is elected by its membership. Many of the members of LIFFE are prominent U.S. banks and brokers.

D. THE GRAIN AND FEED TRADE ASSOCIATION

The Grain and Feed Trade Association ("GAFTA") was established in 1971 as an amalgamation of two organizations which had operated in the physical grain trade for nearly 100 years. GAFTA has an international reputation in the grain world, providing standard form physical grain contracts and arbitration facilities for those involved in the grain trade worldwide. It owns and administers the London Grain Futures Market, which was established in 1929, and the clearing house which clears the wheat and barley contracts traded on that market.

GAFTA provides the secretarial services for the following markets, which it also represents in this Statement:

(1) The GAFTA Soya Bean Meal Futures Association Limited;

(2) The London Potato Futures Association Limited; and

(3) The London Meat Futures Exchange Limited.

Soya bean meal, potato, and meat contracts are traded on these markets, which are situated in the Baltic Exchange in London. All of these markets, including the London Grain Futures Market, have many members involved in worldwide trading in commodities. Many of the brokers and dealers who are members of these markets are U.S. FCMs.

E. INTERNATIONAL COMMODITIES CLEARING HOUSE LIMITED

International Commodities Clearing House Limited ("ICCH"), which was established in 1888, is an independent body owned by the major U.K. banks. ICCH clears and guarantees futures and options contracts on LCE, LIFFE, and GAFTA (except GAFTA grain contracts) in accordance with their rules. It also clears and guarantees contracts traded on a number of other exchanges worldwide. ICCH operates a comprehensive system of daily initial and variation margin clearing.

II. THE UNITED KINGDOM REGULATORY STRUCTURE FOR FUTURES MARKETS

The Exchanges provide a forum for risk shifting and price discovery utilized by diverse international interests. Each market is subject to the surveillance of the Bank of England, and English legal principles govern dealings with U.K. and foreign customers. The efficacy of this regime has been such that, to the Exchanges' knowledge, conduct and standards associated with the British markets have never been a source of regulatory concern in the United States.

Largely in response to developments respecting financial markets generally, the Financial Services Bill now before Parliament (expected to come into effect in 1987) will result in substantial enhancement of the customer protection features presently found in British law. Under the statute as drafted, the Secretary of State for Trade and Industry will have the power, and is expected, to delegate extensive regulatory powers to the Securities and Investments Board ("SIB"). As with the U.S. system of regulation, much of the day-to-day, detailed regulation will be carried out by self-regulating organizations under the supervision of SIB.

The Exchanges have supported the recent establishment of a new self-regulating organization, the Association of Futures Brokers and Dealers Limited ("AFBD"), to assist in developing and enforcing customer protection standards. In certain respects, AFBD occupies a role similar to that of the National Futures Association ("NFA") in the U.S. Acting under SIB supervision, AFBD and the Exchanges will promulgate and enforce standards governing dealings between brokers or dealers and customers. These standards will relate to capital requirements, disclosure rules, "know your customer" requirements, and protection of customer accounts.

Some of the standards, involving, for example, restrictions on unsolicited "cold calls" and the establishment of a compensation fund for public customers, may well exceed counterpart U.S. rules.

III. EXCHANGE CONCERNS ABOUT U.S. REGULATION OF THE INTERNATIONAL MARKETPLACE

Unrestricted access to U.K. markets by U.S. traders and to U.S. markets by U.K. traders enhances market liquidity and efficiency, resulting in a better forum for price discovery and risk shifting at each locale and eventually benefitting the global economy. In their dealings with foreign governments, the Exchanges have endeavoured to support this concept of unrestricted access to foreign and U.K. markets so that the benefits of free markets will be available at all markets. Some past activities of the Commodity Futures Trading Commission ("CFTC"), described below, have threatened free access of foreigners to U.S. markets and free access of U.S. persons to foreign markets, including the Exchanges.

A. THE BAN ON FOREIGN OPTIONS TRADING

The CFTC has banned the offer and sale of foreign options to U.S. public customers, while permitting widespread trading in U.S. exchange-traded options. There is no justification for this ban today, and the Exchanges object to continuation of the ban for the following reasons:

1. The continued ban of the sale of the Exchanges' options is discriminatory, anticompetitive, and inconsistent with established U.S. antitrust policies. In view of the obligation imposed upon the CFTC by Section 15 of the Commodity Exchange Act (the "Act") to "take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objectives of this Act, as well as the policies and purposes of this Act, in issuing any order or adopting any Commission rule or regulation," the discriminatory nature of the continuing ban on sale of the Exchanges' options to the U.S. public should be brought to an end as soon as possible.

2. The continuing prohibition on access to the Exchanges on the part of the United States public is injurious to international trade, of which United States participation is a necessary and important part. Furthermore, members of the U.S. public are being unnecessarily prevented from having access to entirely genuine and reputable investment media.

3. The events in the 1970s which gave rise to the options ban related solely to selling practices in the United States and were in no way related to the integrity of the London markets. They involved the sale by unscrupulous U.S. businesses of options which were described as "London options," but which were in the great majority of cases never bought or sold by members of any of the Exchanges, nor did they see the shores of the United Kingdom. The abuses were such as could equally well occur in relation to U.S. domestic option contracts and demanded enforcement of United States law.

4. The CFTC's experience under the U.S. options pilot program has demonstrated that it is now fully capable of regulating U.S. persons engaging in the offer and sale of options contracts. With the advent of the NFA, the CFTC now has available to it additional and clearly adequate resources and a satisfactory mechanism for controlling and regulating in the U.S. the sale of the Exchanges' options to members of the U.S. public.

5. The new regulatory structure described above for the U.K. futures industry should be entirely adequate for the purpose of regulating business in the Exchanges'

options. The AFBD and the SIB will regulate those carrying on business in the United Kingdom who offer such options to members of the public (whether U.S. citizens or others) by imposing strict rules of conduct and requiring segregation of the funds of all clients except those "professional" clients who opt not to have their funds segregated. Furthermore, the facility of compensation will be available to all clients (other than "professional" clients) of brokers and dealers doing business within the U.K., whatever the nationality or residence of those clients. In addition, it is expected that close links will be established between the SIB and the CFTC and between the AFBD and the NFA, enabling cooperation in regulation and customer protection.

For the reasons set out above, the Exchanges urge that the ban on their options should be discontinued and plan to work with the CFTC to that end.

B. THE EXTRATERRITORIAL REACH OF U.S. LAW

A second area of concern on the part of the Exchanges relates to the potential extraterritorial reach of U.S. law and regulation relating to futures trading. The CFTC is currently considering implementation of Section 4(b) of the Act which authorizes the CFTC to develop rules and regulations governing certain activities of U.S. persons offering or selling futures contracts traded on foreign exchanges to U.S. customers. The Exchanges' view is that the CFTC must be very cautious in exercising its powers under 4(b) to avoid unwarranted extraterritorial application of its regulations and to prevent conflicts with foreign law and regulation.

Current CFTC reporting requirements applicable to positions carried by British nationals on United States markets also raise significant concerns about unwarranted extraterritorial exercise of U.S. regulatory powers.

IV. CONCERNS OF THE EXCHANGES ABOUT S. 2045

From the foregoing, it will be apparent that the Exchanges believe that the U.S. government should ensure that attempts to enforce U.S. law outside the territorial boundaries of the United States do not erect unnecessary barriers to international markets and in particular to United Kingdom markets. Any such barriers, whether through enforcement of extraterritorial information demands or otherwise, are to be deplored. For this reason, the Exchanges have strong concerns about three provisions of S. 2045 (the "Bill") and about a recent proposal of the North American Securities Administrators Association ("NASAA").

A. THE EXTRATERRITORIAL EXTENSION OF THE SUBPOENA POWER

A significant concern of the Exchanges relates to Section 102 of the Bill which proposes to amend the Act to authorize the CFTC for the first time to serve subpoenas upon foreign nationals in foreign nations. The current law is that CFTC subpoenas may be served only within the United States. The result of the proposed amendment would be that the CFTC could serve a subpoena on a foreign person who has never had any contact whatsoever with the United States while the foreign person is residing in his home in a foreign country and could thereby force that foreign person to appear in the United States along with his or her documents and to testify and to produce the documents in any CFTC investigation or proceeding. The proposed amendment would thus be a very significant extension of the current CFTC powers. Indeed, it would be an unwarranted extraterritorial extension of U.S. subpoena powers generally.

The proposal is the CFTC's response to a 1984 U.S. Court of Appeals decision, CFTC v. Nahas, 738 F.2d 487 (D.C. Cir. 1984), which invalidated enforcement of a CFTC subpoena served in Brazil upon a citizen of Brazil. In that opinion, the court made it clear that to construe the law as authorizing a court to enforce a CFTC subpoena served on a foreign citizen in a foreign nation

> "would seriously impinge on principles of international law. 'When compulsory process is served [on a foreign citizen on foreign soil], . . . the act of service *itself* constitutes an exercise of one nation's sovereignty within the territory of another sovereign. Such an exercise constitutes a violation of international law.'" *Id.* at 493-94 (quoting *FTC* v. *Compagnie De Saint-Gobain-Pont-A-Mousson*, 636 F.2d 1300, 1313 (D.C. Cir. 1980)).

Extraterritorial service of subpoenas pursuant to Section 102 would violate international law and would constitute an invasion of the sovereignty of foreign nations. If the CFTC were to use this power to serve a foreign person without sufficient minimum contacts with the United States, a serious U.S. Constitutional issue would arise under the Due Process Clause of the Fifth Amendment as well. For these reasons, the provision should not be adopted.

The Exchanges wish to point out the particular sensitivity attached to the proposed Section 102 in the United Kingdom, where extraterritorial exercise of discovery powers by the United States led to enactment of defensive legislation, the Protection of Trading Interests Act of 1980, authorizing the British Government to issue a protective order to a British concern or citizen confronted with a foreign informational demand.

There is an alternative to enactment of Section 102. The Exchanges understand that discussions between British and U.S. regulators, including the CFTC, on the general topic of information sharing are expected soon. Cooperation between governments or regulatory authorities would seem to be the preferred route to information sharing and would avoid the tensions that are likely to accompany adoption of such a unilateral action as the suggested provision.

B. THE EXTRATERRITORIAL EXTENSION OF SECTION 4b OF THE COMMODITY EXCHANGE ACT

The Exchanges also have a concern respecting the application of Section 101 of the Bill to contracts traded on the Exchanges. Section 101 would extend the scope of Section 4b of the Act, a provision relating to fraud in connection with futures contracts traded on U.S. exchanges, to all futures transactions, presumably including transactions on foreign exchanges.

Section 4(b) of the Act, which was adopted less than four years ago (and which should not be confused with Section 4b which Section 101 would amend), relates expressly to fraud in the offer and sale of foreign futures contracts. That section, and CFTC Regulation Section 30.02 which implements it, are well-considered, carefully drawn provisions designed specifically to deal with fraud in foreign futures transactions. As discussed above, the CFTC has not yet fully exercised its powers to adopt regulations under Section 4(b) and is expected to propose such regulations in the near future.

Proposed Section 101 is thus unnecessary as to foreign futures transactions and would be a less precise method of regulating them than current law. The language of Section 101 should therefore be changed so as to make clear that Section 4b would not apply to transactions in foreign exchange-traded futures.

C. THE RIGHT OF FOREIGN PERSONS TO JUDICIAL REVIEW

Section 103 of the Bill proposes the enactment of a new Section 24 of the Act, which provides that (except as otherwise expressly provided in the Act) judicial review of a final order or rule of the CFTC may be obtained only in the United States Court of Appeals for the Circuit in which the person seeking review resides or has its principal place of business. By its terms, this provision fails to provide any possibility of judicial review to foreign persons or entities which neither reside nor have their principal place of business in the United States.

The CFTC purports to regulate foreign persons and entities which enter into transactions on U.S. futures exchanges even though they do not reside or have their principal place of business in the United States. Indeed, the CFTC has brought a number of enforcement actions against such foreign entities. See, e.g., In re Alan J. Ridge & Co., Comm. Fut. L. Rep. (CCH) ¶ 21,819 (1983); In re Banque Populaire Suisse, Comm. Fut. L. Rep.(CCH) ¶ 21,255 (1981); In re Wiscope S.A., Comm. Fut. L. Rep.(CCH) ¶ 20,785 (1979), rev'd, 604 F.2d 764 (2d Cir. 1979). The anomalous effect of the proposed provision would be that the CFTC could initiate and prosecute an enforcement proceeding against such a foreign entity which would then have no ability to obtain judicial review of the Commission's final order in the case against it.

Furthermore, the CFTC has in the past adopted a number of rules which affect foreign exchanges, foreign commodities brokers, and foreign traders as well as domestic entities and indeed in some instances has adopted rules which have a special impact on such foreign entities. See, e.g., 17 C.F.R. § 17.02(b) (reports filed by foreign brokers). Yet under the proposed Section 24, such foreign entities would have no opportunity to obtain judicial review of a similar new rule.

The Exchanges believe that any provisions adopted by Congress for judicial review of final orders and rules adopted by the CFTC should permit interested foreign persons and entities equal access to the United States courts with interested U.S. persons and entities. The United States should not seek to impose its laws on foreigners without permitting them recourse to its courts. Furthermore, it should not treat U.S. entities more favorably in this regard than foreign entities. To bar interested foreign entities from access to the U.S. courts for review of CFTC actions would raise serious questions under the Fifth Amendment Due Process Clause of the U.S. Constitution.

D. STATE REGULATION OF FOREIGN OPTIONS

The Exchanges understand that the North American Securities Administrators Association ("NASAA") has urged that Section 12(e) of the Act should be amended so as to permit state authorities to regulate transactions in foreign options. The Act currently provides that the CFTC has exclusive jurisdiction to regulate options transactions. The uniformity of regulation guaranteed by this provision is extremely important and would be eliminated by the proposal of the NASAA.

As noted above, the Exchanges have urged the CFTC to consider authorizing trading in foreign options. The CFTC has the expertise, the factual background, and the regulatory powers to devise and to enforce appropriate regulations permitting the offer and sale of foreign options. This uniform approach is far preferable to allowing fifty states to adopt and to enforce inconsistent, vague, and contradictory regulations which would in effect act as an unnecessary bar to trading foreign options in the U.S. The Exchanges recommend that the NASAA proposal should not be adopted.

V. CONCLUSION

For the foregoing reasons, the Exchanges respectfully recommend that Congress

(1) should not enact Section 102 permitting extraterritorial service of subpoenas;

(2) should amend Section 101 to exclude foreign exchange-traded futures contracts from the application of Section 4b;

(3) should amend Section 103 to permit foreign persons and entities equal access to the United States courts with U.S. persons and entities; and

(4) should not adopt the NASAA proposal that state authorities be permitted to regulate transactions in foreign options.

The Exchanges appreciate this opportunity to express their concerns regarding S. 2045 and CFTC regulation. The Exchanges have appreciated the courtesy of the members and staff of the CFTC and look forward to continuing to work directly with them.

COMMODITY FUTURES TRADING COMMISSION
WASHINGTON, D.C. 20581

OFFICE OF
THE CHAIRMAN

March 27, 1986

The Honorable Ed Jones
Chairman, Subcommittee on
Conservation, Credit and Rural Development
Committee on Agriculture
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

The Commodity Futures Trading Commission has been apprised of two communications concerning the proposed amendment of the Commodity Exchange Act contained in S. 2045 and in the companion legislative request we previously delivered to the Subcommittee to clarify the Commission's authority to serve subpoenas outside of the United States. The first of these communications, a note dated February 20, 1986 from the government of the United Kingdom to the Department of State (Note No. 29) suggests the view that the mechanism for obtaining information from sources in Great Britain should result from bilateral agreement between our two governments rather than by legislative enactment. This view is echoed in the second communication, a statement dated February 21, 1986 of five London exchanges,[1] which has been sent to the Senate Committee on Agriculture, Nutrition, and Forestry and essentially is included in testimony presented to the Subcommittee March 19, 1986 by the Washington law firm of Arnold & Porter. The statement also expresses concern over the Commission's proposal to amend Section 4b of the Act. Because these communications, and particularly that of the London exchanges, indicate a misapprehension of the effect of the amendments as well as the background of the events that led to their proposal, the Commission offers this brief reply, and requests that it be included in the hearing record of oversight hearings on the Commission which your Subcommittee held on March 18 and 19, 1986.

The Commission has proposed an amendment to Section 6(b) of the Act to clarify the ambiguity created by the decision in CFTC v. Nahas, 738 F.2d 487 (D.C. Cir. 1984) concerning the Commission's authority to investigate trading in U.S. markets by persons and entities located overseas. The amendment derives from the Commission's responsibility for the integrity of the U.S. markets and its purpose is to support the Commission's efforts to that end. Thus, the amendment is directed solely to the detection and prosecution of violations of U.S. law in connection with conduct in United States markets.

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[1] The exchanges on whose behalf the statement was made are: the London Commodity Exchange Company Limited, the Metal Market and Exchange Company Limited, the London International Financial Futures Exchange Limited, the Grain and Feed Trade Association, and the International Commodities Clearing House Limited.

The statement of the London exchanges fails to distinguish the issue of the method by which subpoenas are served overseas, which was the subject of the D.C. Circuit's opinion in FTC v. Compagnie de Saint-Gobain-Pont-A-Mousson, 636 F.2d 1300 (D.C. Cir. 1980), from the issue of whether extraterritorial service of subpoenas is authorized in the first instance, regardless of the method of service employed, which was the subject of the decision in CFTC v. Nahas. The CFTC proposed amendment principally addresses the latter issue.

The Commission has sought congressional clarification of its authority to serve subpoenas extraterritorially because the Commission considers that authority to be critical to its ability to investigate possible violations of the Commodity Exchange Act by persons located overseas. The Commission does not anticipate that exercising this extraterritorial authority will be a routine matter. However, the need to be able to exercise such authority in appropriate cases has grown as participation in United States futures markets has become increasingly international in character.

The Commission is sensitive to the concerns which appear to belie both the British Government note and the statement of the London exchanges. The Commission has traditionally consulted with the State Department, as it did in the Nahas case, to find a means of contacting foreign nationals in a way that seeks to avoid offending the foreign nation. The Commission intends to maintain that practice, where practicable.

In like fashion, although dependent on the facts and circumstances of a particular case, where appropriate the Commission intends to consult through the State Department with the representative of the receiving nation with a view toward minimizing any perceived intrusion upon that nation's sovereignty. In addition, where there are particular treaties or governmental mutual assistance guarantees, the Commission would contemplate utilizing them to the extent practicable.

The Commission wishes to assure the Subcommittee, the British Government and London exchanges, as well as other interested persons of its sensitivity to the concerns expressed in the two communications and its desire to perform its responsibilities to maintain the integrity of the U.S. markets in a way that will take those concerns into consideration.

In their statement, the London exchanges also expressed concern that the Commission's proposal to delete from Section 4b of the Act the reference to futures contracts traded "on or subject to the rules of any contract market" could be read to extend the antifraud coverage of Section 4b to futures contracts traded on foreign exchanges. The Commission wishes to make clear that its proposal to amend Section 4b is primarily intended to supplement the Commission's enforcement efforts under Section 4(a) of the Act, which makes it unlawful to market off-exchange futures contracts in the United States. The amendment would clarify that purveyors of illegal off-exchange futures contracts in the U.S. who also commit fraud could be charged under the antifraud provisions of Section 4b of the Act, as well as Section 4(a). The Commission anticipates, therefore, that an amended Section 4b would most often be invoked in cases also alleging violations of Section 4(a). In this connection, it should be pointed out that Section 4(a) exempts the sale of futures contracts traded on or subject to the rules of exchanges located outside the United States.

The Commission nevertheless agrees with the London exchanges that amended Section 4b can be read to cover fraud committed in connection with foreign futures contracts. However, this is not a new concept under the Commodity Exchange Act. As the London exchanges indicate, another section of the Act, Section 4(b), and Commission Rule 30.02 presently deal with foreign futures contracts. Section 4(b), enacted in 1982, supplements existing Commission authority under 2a(1) and 4c and authorizes the Commission to develop regulations -- including antifraud regulations -- governing the marketing of foreign futures contracts by persons located in the United States. Those regulations may not govern the rules or actions of foreign exchanges or the terms of their contracts. Rule 30.02, adopted in 1975, prohibits fraud in connection with the marketing in the United States of contracts traded on foreign commodity exchanges. This Rule could be used, for instance, to stop the flow of fraudulent solicitation materials into the United States.

The Commission wishes to assure the Subcommittee and the London exchanges that, given the stated purposes underlying its Section 4b proposal and its existing authority under Section 4(b) and Rule 30.02, the Commission would not charge Section 4b violations in connection with activity that occurs on a foreign board of trade. However, there may be instances, particularly involving fraudulent retail sales practices in the United States, when the Commission should be able to proceed under Section 4b in cases where fraud is committed upon U.S. citizens in connection with foreign futures contracts. Further, violations of Section 4b clearly may be prosecuted criminally, whereas violations of Rule 30.02 or Section 4(b) rules arguably may not. Thus, for example, the Commission could invoke Section 4b against operators who entice United States citizens to trade on the London exchanges but who either have no intention of sending customers' money to London for that purpose or intend to churn the customers' accounts to generate commissions. Such fraudulent conduct amounts to nothing less than theft and is appropriately the subject of Commission and criminal law enforcement action. The Commission is confident that the London exchanges would agree that the misuse of their name and reputation in such unlawful conduct should not go unpunished.

The Commission wishes to emphasize that, in keeping with the restrictions in Section 4(b), antifraud enforcement efforts under Section 4b involving foreign futures contracts would not be directed at the rules of, or trading practices occurring on, the London exchanges, or at the terms or conditions of their futures contracts, but rather at the unscrupulous operators who seek to commit fraud in the United States. For this reason the Commission did not oppose an amendment to Section 101 of S. 2045 to make clear that Section 4b of the Act does not apply to activity occurring on foreign exchanges. The Senate Committee on Agriculture, Nutrition, and Forestry accepted this amendment in voting favorably on S. 2045 on March 25, 1986. A copy of the amendment is attached. The Commission would not object to a similar amendment to its proposal to amend Section 4b at such time as its proposed reauthorization legislation is introduced in the House and is considered by your Subcommittee.

Sincerely,

Susan M. Phillips

Susan M. Phillips
Chairman

cc: The Honorable Kika de la Garza
The Honorable Edward R. Madigan
The Honorable E. Thomas Coleman

Attachment

Item I. A.--Fraudulent Practices

Section 4b - Amendment

Add the following at the end of section 4b of the Commodity Exchange Act:

"Nothing in this section shall apply to any activity that occurs on a board of trade, exchange, or market or clearinghouse for such board of trade, exchange, or market located outside the United States, its territories or possessions involving any contract of sale of any commodity for future delivery, made, or to be made, on or subject to the rules of such board of trade, exchange, or market.".

REVISED COPY

Testimony of Stephen F. Selig

Chair

Committee on Commodities Regulation
of
The Bar Association
of the
City of New York

Mr. Chairman and members of the Subcommittee, my name is Stephen F. Selig and I serve as the Chair of the Committee on Commodities Regulation of the Bar Association of the City of New York. I presently am a partner in the New York law firm of Baer Marks & Upham. In addition, in 1975 and 1976, I served as a member of the CFTC Advisory Committee on the Definition and Regulation of Market Instruments.

My purpose here today is to suggest that the Subcommittee consider expanding the so-called forward contract exclusion contained in Section 2(a)(1)(A) of the Commodity Exchange Act to reflect the changes in off-exchange transactions among commercial firms, financial and other institutions and other like parties which have evolved in the nearly 64 years which have elapsed since the Act, including the forward contract exclusion, was enacted. I am not going to discuss the interpretation of the Treasury amendment, nor am I going to express an opinion on whether leverage transactions should be removed from the Act. These are subjects which our Committee has not considered.

The Association of the Bar of the City of New York, an organization founded in 1870, is composed of 15,000 lawyers and has members in 50 states and many foreign jurisdictions. The Association's Committee on Commodities Regulation consists of 29 members and is a representative cross section of the New York commodity bar. I have attached a list of the Committee members to my written statement.

Last year, our Committee produced a report entitled "THE FORWARD CONTRACT EXCLUSION: An Analysis of Off-Exchange Commodity-Based Instruments." The Report, which is 56 single-spaced pages long and contains 209 footnotes, is scheduled to be published in the May 1986 issue of The Business Lawyer, a publication of the American Bar Association. I am not going to read the Report to you. However, I have furnished a complete copy to both Bob Cashdollar and Phil Fraas, so that it is available for the Subcommittee's use.

Basically, the Report concludes that the Act should be amended to create a non-exclusive "safe harbor" to cover off-exchange transactions where each party to the transaction is a commercial, financial or institutional entity. There are two reasons for this legislative recommendation: (1) the present state of the law is not completely clear, a situation which inhibits the utilization and growth of commercial off-exchange markets and the development of new trading and hedging vehicles and strategies; and (2) it is uncertain whether the CFTC has authority to address this question by regulation.

Since 1922, the Act in substance has provided that a futures contract does "not include any sale of any cash commodity for deferred shipment or delivery." This language commonly is referred to as the "forward contract" exclusion. I think it is safe to say that the forward contract exclusion was added to the Act because Congress did not intend to subject to regulation the activities of commercial interests in the grain industry: those who purchased and sold grain either for immediate or deferred delivery. However, because the statute speaks in terms of "deferred shipment or delivery," it is not clear that the CFTC, by regulation, can exclude off exchange transactions which may not contemplate delivery even though we now have futures contracts which do not provide for delivery at all.

In this regard, over the years, typically in cases involving fraud or near fraud, courts have found off-exchange transactions involving "forward delivery" of commodities to be illegal off-exchange futures contracts. This result may well be desirable in the context of protecting the public from being victimized. However, these cases have set down the following broad factors which by themselves could lead to a finding that an off-exchange transaction is an illegal futures contract even in the absence of fraud:

1. standardization of terms;
2. no expectation or possibility of delivery;
3. margin payments required from the buyer;
4. speculative purpose; and
5. sales to the general public.

The fact is, however, that commercial off-exchange transactions may involve one or more of the first three factors listed. In addition, an activity which might be considered to be "speculative" in traditional commodity markets may constitute portfolio risk management (analogous to hedging) to an institutional securities investor.

Indeed, as we also know, even in the relatively short time since the CFTC has been in existence, the nature of the futures industry and the types of parties who use futures have changed dramatically. I think there are very few persons who would have predicted in 1975 that the most actively traded futures contracts would be those involving financial instruments and stock indices and that banks, mutual funds, insurance companies and pension plans subject to ERISA would be major participants in these markets.

Because of these changes, the nature of off-exchange risk-shifting vehicles and strategies also has changed. One reason for this change is that exchange traded instruments by definition are standardized, while entities may wish to hedge using a non-standardized vehicle. For example, a mutual fund may wish to hedge a specific portfolio and not rely on the S&P 500 index futures contract (or some other stock index futures) and a sophisticated FCM may be willing to provide such protection and use the futures market itself to hedge its risk. Our Committee believes that there is no reason why parties such as these should not be able to enter into such a transaction free of the risk that the transaction could be found to be an illegal off-exchange futures contract because "delivery" was not contemplated or was not possible. Our Report contains other examples.

For this reason, our Committee recommends a safe harbor for transactions between commercial, financial and institutional parties. The Committee believes that this test is easy to apply and enforce. It operates on the simple presumption that the commercial nature of the parties is evidence of the commercial nature of the transaction.

Our Committee Report does not contain suggested statutory language. An approach (similar to the approach Congress used in Section 4a(3) of the Act with respect to the definition of hedging) which occurs to me is to amend Section 2(a)(1)(A) to also exclude from the definition of futures delivery transactions between parties which are commercial, financial or institutional entities and such other transactions or instruments as may be permitted by the Commission by rule, regulation or order consistent with the purposes of this Act. This approach would provide the flexibility needed to deal with new trading concepts which may be developed in the future. In any event, if the Subcommittee is interested in statutory language, I will be pleased to put our Committee to work promptly.

One last comment. Our Committee also considered whether this safe harbor approach should include not only commercial parties but other entities or individuals meeting specific size or net worth standards (for example, accredited investors as defined in SEC Regulation D). The majority of the Committee concluded that it would be appropriate to include such persons within the safe harbor because such persons do not require the many protections contained in the Act. However, a substantial minority was opposed to this approach because of a fear that it could lead to a substantial amount of off-exchange trading, thereby diffusing the market and reducing the effective use of futures for price discovery. Accordingly, our Report does not recommend that such persons be included in the "safe harbor." Rather, we suggest that the CFTC and perhaps Congress study the question.

If there are any questions, I will be pleased to respond.

(Attachment follows:)

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(The attachment, Forward Contract Exclusion: An Analysis of Off-Exchange Commodity-Based Instruments, is held in the committee files.)

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April 22, 1986

Honorable Ed Jones, Chairman
U.S. House of Representatives
Subcommittee on Conservation, Credit
and Rural Development
1336 Longworth House Office Building
Washington, D.C. 20515

Re: CFTC Reauthorization

Dear Congressman Jones:

This statement, submitted on behalf of the Association of the Bar of the City of New York Committee on Commodities Regulation, addresses the proposed legislative changes to the Commodity Exchange Act ("Act") proposed in the bill submitted by the Commodity Futures Trading Commission ("CFTC"). It is in addition to the statement submitted by the Chair of the Committee relating to off-exchange instruments.

Our Committee is comprised of approximately 25 practicing lawyers who specialize in commodity futures law.

We have carefully reviewed the CFTC proposal and have the following comments on a number of these proposals which we believe require further elucidation.

1. Section 101 - Amendment to Section 4b

We agree with the position of the CFTC that bucket shops operating in the United States by making promises with respect to foreign futures should be within the reach of the Act's anti-fraud provisions. However, whether a transaction occurs on an exchange does not determine whether it is legitimate. For example, a large percentage of London Metal Exchange transactions do not occur "on an exchange" since there are only a few ring dealing members who are able to deal on that exchange. Many more entities enter into off-exchange direct contracts covering the commodities that happen to be traded on the LME. This is a completely lawful practice. The CFTC amendment to S.2045 would sweep the bucket shop and the legitimate business together into the ambit of section 4b. In order to protect U.S. citizens without overburdening U.S. courts and interfering with legitimate non-U.S. business, the Congress should clarify that section 4b may only be invoked with respect to fraudulent acts occurring in the United States.

One possible amendment is to add the following language to the end of section 4b:

> "Nothing in this section shall apply to any activity occurring outside the United States or related clerical activity inside the United States involving any contract of sale of any commodity for future delivery made or to be made outside of the United States."

We note that it is our understanding that the CFTC is _not_ seeking to have section 4b cover a transaction effected outside the United States where misconduct with respect to that transaction also occurs outside the United States even though recordation and processing may occur in the United States.

2. Section 102 - Extraterritorial Service of Subpoenas

Section 102 of the CFTC's proposed Bill would amend Section 6(b) of the Act so as to confer extraterritorial subpoena power upon the Commission. Section 102 will empower the Commission to serve administrative subpoenas on persons, including foreign nationals, located outside the United States to compel their attendance and the production of documents, books and records in administrative investigations and proceedings conducted in the United States.[1]

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[1] Section 102 provides in pertinent part: "A subpoena issued under this section may be served upon any person who is not to be found within the territorial jurisdiction of any court of the United States in such manner as the Federal Rules of Civil Procedure prescribe for service of process in a foreign country."

The explanation accompanying the CFTC's proposed amendment to Section 6(b) indicates that it comes in response to the decision of the Circuit Court of Appeals for the District of Columbia in CFTC v. Nahas, 738 F.2d 487 (D.C. Cir. 1984). The Nahas Court held that the CFTC lacked authority to serve an investigatory subpoena abroad upon a foreign national who had extensively traded in the domestic silver futures market through several brokerage accounts. In so ruling, the Court found that Congress had not intended to authorize the CFTC to serve investigatory subpoenas extraterritorially. However, the Court stated that its ruling did not raise a question about the authority of Congress, but rather merely of the intent of Congress.

Although the Committee acknowledges the CFTC's legitimate need for information concerning foreign participants in domestic futures markets, we find Section 102 overbroad as drafted and cannot recommend its adoption. Nevertheless, mindful of the international nature of United States futures markets, and the important economic role played by foreign traders, we believe the CFTC should be given the necessary authority to obtain information from abroad, lest the CFTC otherwise be tempted to restrict foreign participation in U.S. futures markets. Consequently, the Committee would support an amended Section 102 which qualifies its extraterritorial sweep to bring it into conformity with constitutional law and provide due deference to international law.

The CFTC's proposed amendment to Section 6(b) provides an unqualified authority to make service upon persons outside the United States and in so doing concerns of international comity, and foreign relations, as well as the possibility of provoking foreign retaliatory actions suggest that foreign service of CFTC process be cautiously and carefully effected.[2] The CFTC's mission and expertise do not directly relate to foreign law or international relations which are the province of the Department of State. Consequently, to assure appropriate care and sensitivity to foreign law, any CFTC authority under the Act to accomplish extraterritorial service should expressly require prior consultation with the Department of State.

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[2] For example, service of process in the Nahas case invoked strong reaction from the executive and legislative branches of the Brazilian Government. 738 F.2d at 490, 494. Similarly, a spate of foreign retaliatory statutes to Federal Trade Commission service of compulsory process by registered mail is cited by the Saint Gobain Court, supra. 636 F.2d at 1326 n.145.

3. Section 104 - Ex Parte Appointment

The CFTC's proposal contained in Section 104 of the bill would amend Section 6(c) of the Act to empower the agency to seek the *ex parte* appointment of a temporary receiver in a injunctive action brought by the CFTC in federal court. The temporary receiver would serve pending the ultimate hearing on the CFTC's motion for the court to appoint a permanent receiver. Section 6(c) of the Act already authorizes the CFTC to request that a federal court issue an injunction to enjoin unlawful conduct, and grant equitable and ancillary relief to effectuate the court's judgment.[3] The Futures Trading Act of 1982 amended Section 6(c) of the Act to permit courts to issue *ex parte* restraining orders, in a CFTC-initiated injunctive case, which, *inter alia*, prohibit the destruction and removal of the defendant's books and records, and prohibit the disposal or removal of assets of the defendant.

The purpose of a statutory injunction is to deter the defendant and other persons from engaging in further violative conduct.[4] A court will frequently devise ancillary remedies to promote the public interest and to effectuate its judgment in an equitable action brought by the Commission. The appointment of a receiver is a traditional ancillary remedy used to prevent irreparable harm that might result from allowing a defendant to remain in control or possession of the property or entity subject to the court's jurisdiction. The major objective of a receiver in a CFTC-initiated action is to prevent the dissipation of assets procured by the defendant's illegal activities.[5] The CFTC has been successful in persuading federal courts to appoint post-judgment receivers in cases involving proven flagrant, fraudulent and abusive schemes to defraud the public.[6] The decision to appoint a post-judgment receiver traditionally involves balancing the public interest against the adverse consequences that this drastic remedy may have upon a defendant's legitimate interests.

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[3] Standards for injunctive relief in CFTC actions are similar to those applied to injunctions sought by the Securities and Exchange Commission. *See generally* Sackheim, *Judicial Equitable Enforcement of the Federal Commodities Laws*, 32 Am. Univ. L. Rev. 945 (1983).

[4] In *Aaron v. SEC*, 446 U.S. 680 (1980), Chief Justice Burger wrote that "[a]n injunction is a drastic remedy, not a mild prophylactic...." *Id*. at 703 (Burger, C.J., concurring).

The CFTC is already empowered to request an _ex parte_ freeze on books, records and assets pending a hearing on its motion for a permanent injunction. Thus, it does not appear necessary for the court to appoint an individual to manage the affairs of a defendant-entity whose property has been frozen during the pendency of the lawsuit. More appropriately, the CFTC should be empowered to request the appointment of a special master or counsel, whose function would be to make a report to the court concerning the status of such frozen property and assets.[7] Assuming the court had been convinced by the CFTC that the public interest warranted an _ex parte_ freeze order, there appears to be no function that a _temporary_ receiver could fulfill pending the appointment of a _permanent_ receiver. The permanent receiver, whose functions include, _inter alia_, marshalling assets and overseeing the disgorgement of illegally obtained profits, will not be aided in his task by the appointment of a costly temporary receiver, where the assets and other property have already been frozen. Where a defendant violates the court's _ex parte_ freeze order, adequate remedies presently exist which empower the court to punish one who is in contempt of the court's lawful order.

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[5] See, _e.g._, _CFTC v. Morgan, Harris & Scott, Ltd._, 484 F. Supp. 669, 677 (S.D.N.Y. 1979) (the appointment of a receiver is appropriate when necessary to protect the public interest or to prevent the diversion or waste of assets).

[6] In its 1985 fiscal year, the CFTC was successful in having 11 permanent receivers appointed in its federal court injunctive actions. 1985 _CFTC Annual Report_ 28.

[7] See, _e.g._, the Investment Company Act of 1940, 15 U.S.C. § 80a-41(e), which empowers the court to appoint a trustee for entities that violate the securities laws' registration provisions.

In the event that the CFTC believes that someone must step in immediately to manage the business of a defendant-entity, such as where the individual defendants are unable to perform their management functions or there exists evidence of assets being dissipated, it may request an immediate hearing. After a hearing in which the defendant has an opportunity to be heard, the court may appoint a temporary receiver in instances which require such ancillary relief. However, the appointment of a temporary receiver is a drastic measure which should only be invoked after affording a defendant, whose property and assets have already been frozen on an ex parte basis, the right to present testimony and evidence on its own behalf. Such a hearing may be expeditiously convened, and the court will have an opportunity to consider both the public's interest and the interests of an entity which may be irreparably harmed by the imposition of such a drastic form of equitable relief.

The CFTC, as a zealous advocate of the public good, sometimes requests a court to issue inappropriate relief. In CFTC v. Comvest Trading Corp.[8] the court found that a futures commission merchant violated the net capital requirements in the Act[9] and CFTC regulations[10] by incurring net liabilities in excess of $500,000 while maintaining assets of less than $11,000.[11] The CFTC requested the appointment of a receiver, and the individual defendants argued that they should be allowed to continue to control and manage the firm in order to salvage as much as possible from the ongoing business. The court, which had already issued an order prohibiting any dissipation of business assets,[12] applied a public purpose test to the issue of the appointment of a receiver. The court concluded that the CFTC, as the moving party, had the burden of showing that the benefits of appointing a receiver would outweigh the resulting burdens, including the costs of the receivership. Finding no evidence that the total assets of the company were greater than the costs of appointing a receiver, the court concluded that a receiver would not serve the public interest and refused to grant this extraordinary remedy.[13] Had the CFTC's motion been made *ex parte*, the court most probably would have appointed a costly receiver, only subsequently to have to conduct a hearing and rescind the appointment because of the CFTC's inability to prove the necessity of such extraordinary relief.

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[8] 481 F. Supp. 438 (D. Mass. 1979).

[9] Section 4f(2) of the Act.

[10] CFTC Minimum Financial Requirements - futures Commission Merchants, 17 C.F.R. § 1.17 (1982).

[11] CFTC v. Comvest Trading Corp., 481 F. Supp. 438, 439-42 (D. Mass. 1979).

For all of the foregoing reasons, the Commission's proposal providing for the *ex parte* appointment of a temporary receiver pending the outcome of litigation initiated by the agency is inappropriate and would not be in the public interest. Adequate remedies presently exist to prevent the dissipation of an entity's assets in a Commission-initiated federal court injunctive action. As a prerequisite for displacing the present management of an entity that is presumed innocent of wrongdoing, a federal district court is already empowered to convene on an expeditious basis an evidentiary hearing to determine the necessity of such drastic and costly relief.

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[12] *Id*. at 442.

[13] *Id*.

If the Subcommittee wishes any further information on the matters discussed in this letter, we will be pleased to respond.

Charles P. Nastro

Charles P. Nastro, Chair
Subcommittee on Reauthorization

Stephen F. Selig, Chair
Committee on Commodities
Regulation

cc: Robert A. Cashdollar
Kenneth M. Raisler

March 24, 1986

The Honorable Ed Jones, Chairman
Subcommittee on Conservation, Credit and Rural Development
1301 LHOB
Washington, D.C. 20515

Dear Congressman Jones:

I am submitting this letter of statement for the record relative to hearings you held in Washington March 19th concerning reauthorization of the Commodity Futures Trading Commission.

In all probability, more people are aware today of the massive problems in American agriculture due to disastrously low farm commodity prices than at any other time in history.

In my oponion, a substantial part of the problem of low farm commodity prices is due to the fact that current commodity futures trading regulations legalize price-depressing practices by participants in commodity futures trading.

For Example:

1. On any given trading day, an unlimited number of people can sell futures contracts representing commodities they can't produce and don't even own to begin with (termed speculative short selling);
2. Furthermore, these sellers sell at prices the actual owner of the commodity never agreed to take:
3. These sellers also make it possible for processors, users and exporters of farm commodities to lock in a price for the commodity they need and by-pass the actual owner of the commodity in the process. The CFTC has been fully aware for at least 5 years of these problems yet we have not witnessed any substantial progress on their part to correct the highly unfair, unreasonable pricing problems for farm commodities.

Yet time and again the CFTC has bowed down to the desires of the futures industry while totally ignoring farmers. For example, March 19, 1986 Wall Street Journal reported that the CFTC has compromised a plan to require that commodity exchanges report all pit trades within one minute of the trade (essentially the same requirement as one proposed by farmers thru the Kansas, Oklahoma and Nebraska Wheat Growers Associations in recent years) to a "standard that might be met only 70 - 80% of the time during busy periods.

On the other hand, the CFTC has ignored the fact that a whopping 91.6% of the farmers voting in a poll conducted March 7, 1983 by the Farmer Stockman of the Midwest indicated they "...favor changes in futures trading rules that would give farmers more consideration in the manner in which their commodities are traded and ultimately priced...".

The August 18, 1983 WSJ reported: "Trading sources yesterday again identified the prominent player in the pork belly squeeze as" ... (a) meat-packing firm and bacon slicing concern reported to have purchased rights to take delivery of huge quantities (of pork bellies-bacon)."

August 19, 1983 WSJ reported "... traders were entitled to receive nearly 50 million pounds of frozen pork bellies later this month, but the nation's current supply of frozen bellies meeting the contract's specifications amounts to only about 13 million pounds."

Which makes it quite clear that pork processors were able to by-pass the producer in locking in a price for the commodity they needed by buying futures contracts from sellers that didn't even own the commodity to begin with, then calling for delivery of the commodity.

Since the CFTC has refused to correct and restrict these highly abusive futures trading practices as requested on numerous occasions by grain and livestock producers and producer organizations for at least 5 years, I feel it is time for Congress to put the regulation of the commodities markets under the Securitites and Exchange Commission, which has demonstrated a much greater degree of concern for stockholders (May 17, 1982 WSJ: "The SEC is still the world's toughest policeman of insider-trading abuses.."; July 26, 1984 WSJ: "The House voted unanimously to adopt the insider-trading sanctions bill with a few Senate amendments, toughening the penalti against stock traders who profit illegally from inside information."), than the CFTC has demonstated for grain and livestock producers.

Therefore, I respectively request that your Committee take the proper steps to provide grain and livestock producers with a fair and equitable pricing system by moving the regulation of commodity futures trading to the SEC.

Thank you, Mr. Chairman.

Sincerely,

Doug Wildin

Doug Wildin

cc: Rep. Dan Glickman
Rep. Pat Roberts

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April 2, 1986

The Honorable Ed Jones, Chairman
Subcommittee on Conservation, Credit and Rural Development
1301 LHOB
Washington, D.C. 20515

Subject: Testimony in opposition to the re-authorization of the Commodity Futures Trading Commission for 4 more years.

Dear Congressman Jones:

I am a 47 year old farmer. And I have been a farmer for 29 years. I have always lived and worked on the same 650 acre corn and soybean farm west of Danforth, Illinois.

I understand that the Subcommittee on Conservation, Credit and Rural Development held public hearings (3/19/86) concerning the proposed re-authorization of the Commodity Futures Trading Commission. I have some strong opinions about how the CFTC has been doing it's job. I am also sure that because very few farmers know about the CFTC re-authorization hearings that you didn't receive a lot of input from the farming sector. Because I can't afford to come to Washington to testify in person, I am sending it to you in the form of a letter.

Enclosed please find a letter addressed to the Chairman of the U.S. House Agriculture Subcommittee on Conservation, Credit and Rural Development . Would you please have it entered into the official record for the CFTC re-authorization hearings.

In a recent Wall Street Journal article they quoted you as telling Ms Phillips (the CFTC Chairwoman) that your subcommittee won't hold the CFTC re-authorization hostage to the solution to the audit trail dispute. I sure hope this was a mistake, because if the CFTC is re-authorized before the audit trail dispute is resolved, **I am sure** the CFTC will quietly back away from the one minute trade recording rule and **go back asleep for another four years** and it will business as usual in the pits. And that will not be good for American agriculture.

Please Don't Vote for the re-authorization of the Commodity Futures Trading Commission for 4 more years. As far as I am concerned, they are a part of the farm problem and an ideal place to save federal tax money. **Please Vote to move the responsibility** for regulation of the commodity futures markets to the Securities Exchange Commission (SEC). If, as I hope, the CFTC is closed down, please do not move personnel from the old CFTC to the SEC, we need a totally new direction in the regulation of our futures markets, not business as usual under a new name. And besides it would be unconscionable to reward people for doing nothing.

You may call me at (815) 269-2652 at any time.

Thank you,

Roy D. Wilken
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April 2, 1986

The Honorable Ed Jones, Chairman
Subcommittee on Conservation, Credit and Rural Development
1301 LHOB
Washington, D.C. 20515

Subject: Testimony in opposition to the re-authorization of the Commodity Futures Trading Commission for 4 more years.

Dear Congressman Jones:

When you first look at the Commodity Futures Trading Commission's official seal with its eagle perched on top of a plow and gear holding a balance scale in it's mouth you are lead to believe that the CFTC is a branch of the U.S. government that provides justice in the marketplace equally to agriculture and industry. When in fact nothing could be further from the truth. Since it's inception the Commodity Futures Trading Commission has been a total disaster for American agriculture. In fact whenever the Commission has been forced to make a decision between the often conflicting interests of agriculture and the grain trade or the futures industry, agriculture always loses.

In August 1984 the then president of the Chicago Mercantile Exchange, Mr. Clayton Yeutter, told a reporter from the Wall Street Journal that the incoming Reagan administration had sought help in selecting a new chairman for the CFTC "in fact the exchanges took the initiative" in selecting all five members of the commission, including the current chairman Ms. Susan Phillips. I remember thinking with all the members of the CFTC being hand picked by the futures industry, I certainly hope they are going to be fair. But alas it was not to be.

The Commodity Futures Trading Commission has repeatedly refused to address the outrageous flaws in our corrupt marketing system; flaws that allow the markets to be manipulated by large commodity buyers using large short futures trades to hammer down cash commodity prices, which they can then buy at a lower price. Before Congressional hearings held in 1984, CFTC commissioner, Flower West and Vice Chairman of the Chicago Board of Trade, Neal Kottke, admitted that commodity markets could be manipulated in that way. You can be sure if someone was stealing from the futures industry or the grain trade the CFTC would have done something about it by now.

The Commodity Futures Trading Commission refuses to even look into regulating speculative short trading which is the major flaw in the futures market. The short speculator sells a commodity he doesn't own and can't produce hoping to profit by buying it back at a future date at a lower price. The short speculator really doesn't have a legitimate economic interest in the commodity because he doesn't have a cost to protect. The short speculator's sales compete with the commodity producers hedge sales and the cash commodity buyers hedge sales for the buyers that are in the market and thereby increases the apparent supply of the commodity and therefore

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reduces the commodity futures price. Because the cash commodity price closely follows the commodity futures price, the short speculator steals from every commodity producer. In fact holding a short speculative position is a form of stealing. This is why the futures market can continue to go down even though producers are not selling because the price is below the cost of production.

Before the tragic stock market crash in 1929, trading rules allowed speculative short trading. These rules were very similar to the unfair speculative short trading rules that farmers are forced to live with now on the commodity futures markets. After the crash Congress set up the Securities Exchange Commission (SEC). Because uncontrolled speculative short trading may have played a large roll in the stock market crash, and because it was perceived that securities that are traded in a market that allowed speculative short trading tended to be priced lower, trading rules were changed, and now speculative short trading on the stock market is very strictly regulated. Today a speculator can sell stock he doesn't own, only if he first borrows it from someone who does, and only if the market is going up. As a farmer I wonder why the same reforms weren't extended to the commodity futures markets?

It is true that recently The Commodity Futures Trading Commission has put forth a number of proposals including the new 1 - minute recording rule that if enacted would be very beneficial to the commodity producers at the expense of the futures industry for a change. I think these are just a smoke screen to reduce producer objections at the CFTC's reauthorization hearings. After hearing all the crying about the new 1 - minute recording rule from the futures industry, it is my guess that if the CFTC is reauthorized they will quietly drop it. In fact a recent Wall Street Journal article (3/ 9/86) indicates that the CFTC already shows signs it will compromise on the reporting rule. Its going to be happy days are here again in the pits.

Please Please do not reauthorize The Commodity Futures Trading Commission!! I don't think American agriculture can stand another four years of their pseudo regulation. As far as I am concerned the CFTC is a major part of the farm problem and a ideal place to save federal tax money. Please give the responsibility for regulating the futures markets to the Securities Exchange Commission (SEC). you can be sure they understand the dangers of unregulated speculative short trading.

Thank you,

Roy Wilken

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